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In the Supreme Court of the United States

October Term, 1960

No. 599

People of the State of California and
Public Utilities Commission of
the State of California,
Petitioners,

vs.

Federal Power Commission,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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In the Supreme Court of the United States

October Term, 1960

No. ....

People of the State of California and
Public Utilities Commission of
the State of California,
Petitioners,

vs.

Federal Power Commission,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

The petitioners, the People of the State of California and the Public Utilities Commission of the State of California, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above-entitled case on August 2, 1960.[1]

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[1] The above-entitled case, Docket No. 18125 in the court below, was brought by petitioners on petition to review and set aside orders of the Federal Power Commission issued in a rate proceeding known as *In the Matter of El Paso Natural Gas Company*, Docket No.

OPINIONS BELOW

The opinion of the Court of Appeals (App., *infra*, pp. 1 to 13) is reported at 281 F.2d 567. The Federal Power Commission's Opinion and Order Determining Rates and Providing for Refund (Opinion No. 326) issued on August 10, 1959 (R. 162-221) and its Opinion and Order Denying Rehearing and Granting Stay (Opinion No. 326-A) issued on October 8, 1959 (R. 259-276) in the proceeding entitled "In the Matter of El Paso Natural Gas Company", Docket No. G-4769, are reported at 22 FPC 260 and 22 FPC 659.

JURISDICTION

The judgment of the Court of Appeals was entered on August 2, 1960 (App., *infra*, pp. 14 to 15). On August 22, 1960, petitioners timely filed a petition for rehearing pursuant to Rule 29 of the Rules of the United States Court of Appeals for the Fifth Circuit.[2] The petition for rehearing was denied by order of the Court of Appeals without opin-

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G-4769. Petitions to review and set aside said orders in said proceeding were also filed in the court below by El Paso Natural Gas Company (No. 18022), Southern California Gas Company and Southern Counties Gas Company of California (No. 18120), and Pacific Gas and Electric Company (No. 18124). El Paso Natural Gas Company was permitted to intervene in Nos. 18120, 18124 and 18125 by order of the court filed on January 12, 1960 (R. 59). Although not formally consolidated, the four cases were considered by the Court of Appeals on a record printed as a joint appendix to all opening briefs, were orally argued at a single hearing, and were disposed of by a single judgment and opinion.

[2] Rule 29 provides: "A petition for rehearing may be presented only within twenty-one days after entry of judgment, unless by special leave granted by the court, or one of the judges. Twenty copies must be filed, accompanied by proof of service. It must be printed and must briefly and distinctly state its grounds without argument, be supported by certificate of counsel to the effect that it is presented in good faith and not for delay, and if petitioner desires, he may file a written brief in support. The petition will not be granted or permitted to be argued unless a majority of the court so determines."

ion on September 30, 1960. The court's judgment entered on August 2, 1960, therefore became final on September 30, 1960. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717(r).[3]

QUESTION PRESENTED

In determining by use of the traditional rate base method whether the rates of a natural gas company are just and reasonable pursuant to Section 4 of the Natural Gas Act, may the Federal Power Commission lawfully include in the company's cost of service a hypothetical amount for federal income taxes in excess of actual taxes, such hypothetical or "phantom" taxes being based on a pretense, indulged in for rate making purposes, that the company has taken a tax deduction calculated on the basis of straight line depreciation when in fact it has taken a greater tax deduction calculated on the basis of liberalized, or rapid, depreciation optionally allowed by the provisions of Section 167 of the Internal Revenue Code of 1954, and when in fact it has thereby reduced its actual tax expense over that which would have obtained had straight line depreciation been employed for tax purposes?[4]

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[3] The Natural Gas Act is the Act of June 21, 1938, c. 556, 52 Stat. 821-833, as amended; 15 U.S.C. 717-717w.

[4] The terms "liberalized depreciation", "accelerated depreciation", and "rapid depreciation" are ordinarily used interchangeably and refer to the use of the declining balance method of accounting for depreciation expense for federal income tax purposes optionally permitted under Section 167, I.R.C. (1954), which results in higher deductions for depreciation in the earlier years of the life of an asset and lower deductions in later years; these terms are to be distinguished from "straight line depreciation" which results in equal annual deductions for depreciation over the life of an asset.

STATUTES INVOLVED

Inasmuch as the statutes involved are lengthy their pertinent text is set forth in the Appendix, *infra*, pp. 17-25. The citations to them are:

1. Natural Gas Act, Sections 4(a), 4(d), 4(e), and 5(a) (52 Stat. 822, 823; 15 U.S.C. 717c, 717d).

2. Internal Revenue Code of 1954, Sections 167 and 168 (68A Stat. 51, 52, as amended, 71 Stat. 414 and 72 Stat. 1608; 26 U.S.C. 167 and 168).[5]

STATEMENT OF THE CASE

A. The Parties and the Nature of Their Interests.

The parties to the proceeding in the court below are:

1. Petitioners, People of the State of California and Public Utilities Commission of the State of California, hereinafter called California. The Public Utilities Commission of the State of California is an independent constitutional commission authorized to regulate public utilities subject to its jurisdiction (California Constitution, Article XII, Sections 22-23).[6]

2. Respondent, Federal Power Commission, an independent commission established pursuant to the Federal Power Act (Act of June 10, 1920, c. 285, 41 Stat. 1063, as amended; 16 U.S.C. 791, et seq.), hereinafter called Commission. Under the Natural Gas Act the Commission is charged with the duty of regulating the rates of natural gas companies subject to its jurisdiction.

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[5] The Internal Revenue Code of 1954 is the Act of August 16, 1954, 9:45 A.M.-E.D.T., c. 736, 68A Stat.

[6] The attorney for the Public Utilities Commission of the State of California is empowered to "represent and appear for the People of the State of California and the commission" in proceedings involving the regulation of public utilities (California Public Utilities Code, Section 307).

3. Intervener, El Paso Natural Gas Company, a Delaware corporation, hereinafter called El Paso. El Paso is engaged in the business of producing, transporting and selling natural gas in interstate commerce subject to the jurisdiction of the Federal Power Commission. It is a natural-gas company as defined by Section 2(6) of the Natural Gas Act (52 Stat. 821, 15 U.S.C. 717a). It sells large volumes of natural gas in interstate commerce to such California public utility gas companies as Southern California Gas Company and Southern Counties Gas Company of California (Southern California Companies) and Pacific Gas and Electric Company (P.G.&E.)[7] which in turn distribute such gas to millions of customers residing in the State of California.

The natural gas sold by El Paso is produced principally in Texas and New Mexico and is transported by pipeline for delivery at the Arizona-California border to its customers in California such as the aforementioned California public utility gas companies. El Paso is a so-called integrated company in that it not only transports and sells natural gas by pipeline but produces a portion of the gas transported and sold.

At the present time almost 3,000,000,000 cubic feet of gas per day is transmitted through El Paso's interstate pipeline system. Over two-thirds of El Paso's gas is sold to California gas distributing public utilities for resale to cus-

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[7] The total jurisdictional sales of natural gas by El Paso Natural Gas Company for the year 1955 were (Exhibit No. 1; Schedule No. 3; R. 101):

	Amount	Percentage
Southern California Companies	$ 60,552,071	44.5%
Pacific Gas and Electric Company	59,691,859	44.0
Other companies	15,636,102	11.5
Total jurisdictional sales	$135,880,032	100.0%

tomers in California, of which there are more than four million. Although such gas distributing companies as Southern California Companies and P.G.&E. are public utilities within the meaning of Section 216(a) of the California Public Utilities Code and subject to the regulatory authority of the California Public Utilities Commission, including the fixing of rates and charges for the sale of natural gas (California Constitution, Article XII, Sections 22, 23; California Public Utilities Code, Part 1), the price of the natural gas to the California consumer is largely dependent upon the rates fixed by the Federal Power Commission for the sale of gas by El Paso for resale in California. These rates are therefore a matter of vital concern to California which is protecting the interests of its gas consumers, the vast majority of whom are served by the public utility gas companies aforementioned.

B. The Proceeding Before the Commission.

Pursuant to Section 4(d) of the Natural Gas Act, El Paso filed with the Commission on October 14, 1954, new schedules which provided for increased rates for the sale of natural gas to its customers including Southern California Companies and P.G.&E. The matter having been docketed as No. G-4769, the increased rates proposed by El Paso were suspended by the Commission and were permitted to go into effect on April 15, 1955, subject to refund, pending a determination by the Commission of the lawfulness of such rates (Natural Gas Act, Section 4(e)). These rates remained in effect until December 31, 1957, when rate schedules filed by El Paso in Docket No. G-12948, involving further rate increases, were permitted to take effect.

California, Southern California Companies, P.G.&E., and others intervened in Docket No. G-4769.

On August 10, 1959, the Commission issued its Opinion and Order Determining Rates and Providing for Refund (Opinion No. 326, R. 162-221). Applications for rehearing were filed by California, P.G.&E., El Paso, Southern California Companies, and the New Mexico Public Service Commission, and the same were denied by the Commission by its Opinion and Order Denying Rehearing and Granting Stay (Opinion No. 326-A, R. 259-276).

The Commission's decision had the effect of determining the lawful rates to be charged for the so-called "locked in" period extending from April 15, 1955, to December 31, 1957. Having found that the increased rates proposed by El Paso were neither just nor reasonable, the Commission ordered El Paso to refund the amount it had collected subject to refund in excess of the amount allowed by application of the rates determined by the Commission (R. 207, 208).

In reaching its determination of rates the Commission employed the traditional rate base method. In doing so it calculated El Paso's cost of service for the year 1955 which was selected as the so-called test year (R. 164, 166).

The principal controversy which arose in the proceeding before the Commission related to the calculation of the federal income tax component of El Paso's cost of service (R. 163). In figuring its deduction for depreciation expense for federal income tax purposes, El Paso utilized the declining balance method, a form of liberalized depreciation optionally permitted by Section 167 of the Internal Revenue Code of 1954 (R. 170; see also App., *infra*, pp. 19 to 21). For cost of service puposes, however, El Paso took the position that its federal tax expense should be calculated as if it had utilized straight line depreciation. Such a technique is often called "normalization". Inasmuch as the deduction for depreciation under the straight line method is less than it is under the declining balance method, "normalization" involves an overstatement of federal income tax expense for rate making purposes by a hypothetical amount equal to the difference between taxes calculated on the basis of straight line as compared with liberalized depreciation. The hypothetical, overstated taxes have been described by many as "phantom" taxes.

California objected to "normalization" and contended that El Paso was entitled for rate making purposes to an allowance for federal income taxes equal to its actual taxes with the result that any reduction achieved by the use of liberalized depreciation would inure to the benefit of the ratepayer.

The Commission decided the question by approving "normalization". It found that, for the test year, the difference between hypothetical taxes based on straight line depreciation and actual taxes based on liberalized depreciation was $1,293,717 (R. 170, 174),[8] and directed El Paso to credit this amount to a reserve for deferred taxes which had been set up earlier pursuant to an accounting order promulgated by the Commission in *Amere Gas Utilities Company, et al.*, 15 FPC 760, 781 (1956) (R. 173, 174).

In adopting "normalization" as the treatment to be accorded liberalized depreciation in rate cases, the Commission relied most heavily upon its belief that Congress intended such a result when it enacted Section 167, I.R.C. (1954); moreover, the Commission was of the opinion that use of liberalized depreciation resulted in a tax deferral, not a tax saving. Its opinion in this respect was based on its assumption that lower taxes in earlier years achieved by the use of liberalized depreciation would inevitably be counterbalanced by the imposition of higher taxes in later years (R. 170-174). In justifying its approval of "normalization", the Commission referred to its treatment of accelerated amortization under Section 168, I.R.C. (1954)[9] which also involved crediting the difference in actual taxes calculated by use of accelerated amortization and hypothetical taxes calculated by use of straight line depreciation to a reserve for deferred taxes. The Commission stated that Section 167 was comparable to Section 168 (R. 171).[10]

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[8] A small part of this amount represents "phantom" taxes attributable to similar treatment being given to tax savings achieved by use of the deduction for accelerated amortization under Section 168, I.R.C. (1954); App., *infra*, pp. 21 to 25.

C. The Proceeding in the Court Below.

Pursuant to Section 19(b) of the Natural Gas Act, California, Southern California Companies, P.G.&E., and El

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[9] See *Treatment of Federal Income Taxes as Affected by Accelerated Amortization*, 12 FPC 369 (1953); *Panhandle Eastern Pipe Line Company*, Op. No. 269; 13 FPC ......, 3 PUR 3d 396 (1954) and *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (1955); *cert. den.* 352 U.S. 829 (1956).

[10] There were also questions raised as to the treatment to be accorded the deduction for percentage of income depletion and for intangible well drilling costs. Both these deductions resulted in outright tax savings, as the Commission found. For this reason the Commission treated such tax savings as a form of return on El Paso's production properties (R. 126). It had been stipulated by all parties that El Paso was entitled to earn a rate of return of 6% on its total rate base. Under the Commission's treatment of return as a component of cost of service El Paso was allowed a rate of return of 8.61% on its well mouth properties, such rate of return being based on the tax savings achieved by use of the deduction for percentage of income depletion and for intangible well drilling costs. As for the remainder of El Paso's rate base there was allowed a rate of return of 6% pursuant to the stipulation, with the result that a composite rate of return of 6.35% was allowed on the total rate base (R. 183-186). As with liberalized depreciation, California contended that El Paso was entitled to an allowance for actual federal income taxes only. El Paso, on the other hand, contended that it should be allowed a rate of return of 6% on its total rate base *in addition to* an allowance for federal income taxes based on "normalization" and based on a non-recognition of the fact that it had taken deductions for percentage of income depletion and for intangible well drilling costs.

Paso filed in the Court of Appeals for the Fifth Circuit petitions to review the orders of the Commission in Docket No. G-4769.

California took the position in the court below that the Commission's treatment of the deductions for liberalized depreciation, percentage of income depletion, and intangible well drilling costs was legally improper. The court held that "there is nothing in the legislative history that would warrant our concluding that Congress intended the statutory depletion, deduction of intangible drilling expense, and *rapid depreciation provisions* of the Revenue laws to amend or modify the express language of the Natural Gas Act, * * *"[11] and concluded that actual tax savings resulting from the deductions for percentage of income depletion and intangible well drilling costs were entitled to no different treatment by the Commission than savings in any other cost of service. "The net result of this, of course," the court said, "is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation." (App. *infra*, p. 10).

On the question of liberalized depreciation, however, the court seemed to say that this tax saving was in practical effect a deferral. The court stated (App., *infra*, pp. 11, 12):

> "The one exception, if it be an exception, is the treatment to be afforded the tax saving or deferral resulting from the use by the taxpayer of the declining balance method of depreciation of new equipment. In practical effect this works a tax deferral rather than a tax savings. If the company were charged for rate making purposes with such "savings" during the year in which the depreciable assets were acquired, and the rate resulting from such treatment of the taxes was thereafter used for later years, as is here the case, it

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[11] App., *infra*, p. 9; emphasis supplied.

> is clear that the company would be paying higher taxes in subsequent years than in the test year, but would not be entitled to an adjustment in rates to cover the increase. Therefore, we approve the Commission's treatment of the "saving" resulting from using the declining balance method of depreciation for tax purposes but computing its taxes for rate making purposes on the straight line method of depreciation, placing such "savings" in a special reserve to be used to equalize tax payments in later years. These amounts can never represent added return to the company because of the restriction as to their use."

The court having decided that the Commission had improperly permitted El Paso to retain tax savings achieved by its use of the deductions for percentage of income depletion and intangible well drilling costs, the Commission's determination of the allowable return and rate of return on well mouth properties was thereby invalidated. The court therefore remanded the cause to the Commission so that it could receive "such evidence as may be necessary to enable it to fix a just and reasonable rate to permit a fair return on the well-mouth investment and provide the incentive necessary to attract capital to the exploration and development activities of the company." (App., *infra*, pp. 12, 13).

California filed with the court below a timely petition for rehearing raising the identical question which is presented for this Court's consideration, i.e., whether rates for the sale of natural gas in interstate commerce may properly be predicated on the basis of a cost of service which includes an allowance for federal income taxes based on the hypothesis that the company has utilized straight line depreciation for tax purposes when in fact it has employed liberalized depreciation so as to achieve a lower tax liability.

REASONS FOR GRANTING THE WRIT

This case presents a question the resolution of which has far reaching effects on basic regulatory law. The approval by the court below of the Commission's treatment of liberalized depreciation for rate purposes constitutes a serious and unjustified departure from the conventional principles of rate making long employed by regulatory agencies, including the Commission, and long sanctioned by this Court. The Commission's treatment improperly requires ratepayers to pay for a non-existent expense. It improperly compels consumers to contribute capital to a natural gas company, capital which is credited to a permanent reserve account on the untrue assumption that such contributions are for "deferred" taxes. It improperly deprives consumers of the benefit of lower rates which would otherwise reflect the tax savings achieved by the use of liberalized depreciation. In all these respects, the treatment approved by the Court of Appeals is contrary to the primary purpose of the Natural Gas Act, which, as this Court has said (320 U.S. 591, 612 (1944)), "is to protect the consumer interests against exploitation at the hands of private natural gas companies." For these reasons, the case fully deserves review here.

From a practical point of view, the best measure of the tremendous impact "normalization" has on consumers of natural gas is to be found in the history of the reserve for "deferred" taxes. In the case of El Paso alone, the following growth in the reserve has been experienced:[12]

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[12] This information is shown in El Paso's annual reports to the Commission (Form 2).

Year	Amount
1954	$ 605,867.57
1955	1,295,559.77*
1956	1,839,400.00
1957	5,540,000.00
1958	4,060,400.00
1959	8,552,700.00
Total	$21,893,927.34

For all natural gas companies subject to the Commission's jurisdiction, the reserve shows the following expansion:[13]

Year	Amount
1954	$ 7,778,000
1955	8,640,000
1956	22,843,000
1957	31,934,000
1958	33,010,000
1959	48,260,000
Total	$152,465,000

Such an accumulation of "phantom" taxes demonstrates the importance of the question presented by this case to the proper administration of the Natural Gas Act and emphasizes the need for resolution by this Court of the problem posed.[14]

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*It is to be noted that this amount is slightly greater than the amount ($1,293,717) to be credited to the reserve as determined by the Commission for the test year 1955. The difference is explained by the fact that the Commission determined that El Paso's depreciation expense should be reduced by $947,671, "both for the purposes of this case and also on its books effective January 1, 1956." (R. 167).

[13] FPC S-142, *Statistics of Natural Gas Companies for 1959*, Table 13.

[14] The issue raised here has never been presented to this Court before. In *City of Detroit, Michigan v. Federal Power Commission*, 230 F.2d 810 (1955), the Court of Appeals for the District of Columbia Circuit approved the Commission's decision in *Panhandle*

1. Only Actual Taxes Have Ordinarily Been Allowed in Calculating the Cost of Service.

In accordance with the fundamental principle that a public utility is entitled to recover its ordinary and legitimate costs through its rates, utilities historically have been allowed by regulatory commissions and courts alike to include tax expense in cost of service for rate making purposes. Inasmuch as taxes are in fact a legitimate cost to the utility, the recovery of taxes from the utility's customers is clearly proper. However, only actual taxes, i.e. taxes paid,[15] have been ordinarily recognized as legitimate costs in calculating the cost of service.

In *Galveston Electric Company v. Galveston*, 258 U.S. 388, 399 (1922), this Court stated:

> "In calculating * * * a proper return, it is necessary to deduct from gross revenue the expenses and charges; and all taxes which would be payable if a fair rate

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Eastern Pipe Line Company, Op. No. 269, 13 FPC .... 3 PUR 3d 396 (1954), to "normalize" taxes with respect to savings generated by the use of the deduction for accelerated amortization under Section 168, I.R.C. (1954) (App., *infra*, pp. 21 to 25). A petition for a writ of certiorari to review the judgment of the Court of Appeals in that case was denied by this Court (352 U.S. 829 (1956)). An examination of the pertinent provisions of Section 168 will show that the deduction there permitted applies only to *emergency facilities* and that it can be taken only for a *specified time*, i.e., for no more than five years. Moreover, the class of property as to which the deduction is applicable is strictly limited. On the other hand, the deduction for liberalized depreciation permitted by Section 167 applies to all property acquired after December 31, 1953, and there is no limitation imposed as to the period over which the deduction may be taken. Because of the very limited application of Section 168, California asserts that the decision in *City of Detroit* does not control the question now presented to this Court, and it remains only to point out that the denial by this Court of a writ of certiorari does not constitute an expression by this Court on the merits of the question presented therein (*Agoston v. Commonwealth of Pennsylvania*, 340 U.S. 844 (1950)).

[15] It would seem that taxes currently payable in a legal sense would deserve to be treated in the same manner as taxes already paid.

> were earned are appropriate deductions. There is no difference in this respect between state and Federal taxes, or between income taxes and others."

See also *Georgia Railway & Power Company v. Railroad Commission of Georgia*, 262 U.S. 625, 632, 633 (1923).

The *Galveston* case has always been construed to mean that a utility is entitled to recover through rates the taxes which it pays and no more. The question there was whether the utility should be allowed to recover taxes at all. This Court having answered in the affirmative it logically follows that actual taxes paid constitute the upper limit which may be recovered through rates, and that it would be improper to impose upon ratepayers any additional burden related either to some additional hypothetical tax or to a tax which is not clearly payable.

Such construction has long been adhered to by the Federal Power Commission.[16] As recently as October 24, 1956, the Commission said in *South Carolina Generating Company*, Op. No. 297, 16 FPC 52, 65 (1956):

> "We have consistently held that allowance for taxes should not exceed taxes paid."

In this connection it is also of interest to note that the Court of Appeals for the District of Columbia Circuit in

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[16] See *Cities Service Gas Company*, Op. No. 95, 3 FPC 459, 484 (1943), *aff'd.* 155 F.2d 694 (1946), *cert. den.* 329 U.S. 832 (1947); *Cleveland v. Hope Natural Gas Company*, Op. No. 76, 3 FPC 150, 183 (1942), *aff'd.* 320 U.S. 591 (1944); *Mississippi River Fuel Corporation*, Op. No. 126, 4 FPC 340, 348 (1945); *Penn. York Natural Gas Corporation*, Op. No. 129, 5 FPC 33, 38, 39 (1946); *Otter Tail Power Company*, Op. No. 186, 8 FPC 393, 402 (1949); *Transcontinental Gas Pipe Line Corporation*, Op. No. 227, 11 FPC 94 (1952); *Northern Natural Gas Company*, Op. No. 228, 11 FPC 123 (1952); *Colorado Interstate Gas Company*, Op. No. 235, 11 FPC 324 (1952); *United Fuel Gas Company*, Op. No. 258 and Op. No. 258-A, 12 FPC 251 (1953); *Hope Natural Gas Company*, Op. No. 262, 12 FPC 342 (1953).

City of Detroit, Michigan v. Federal Power Commission, 230 F.2d 810 (1955), observed that under the rate base method:

> "* * * the rates are set high enough to recover all *costs* of service, including taxes * * *" (230 F.2d at 813; emphasis supplied).

Moreover, the Court of Appeals in reaching its decision in the *City of Detroit* case had before it the Commission's decision in *Panhandle Eastern Pipe Line Company*, Op. No. 269, 13 FPC ......, 3 PUR 3d 396 (1954), wherein the Commission stated:

> "Finally, under the rate base approach allowances for taxes on the production property are made in accordance with the actual payments made * * *" (3 PUR 3d at 409).

With this background of a long established practice by the Commission and by the courts of allowing in the cost of service only actual taxes, the Commission's departure in this proceeding from that concept demands close attention.

2. The Use of Liberalized Depreciation Results in a Tax Saving, Not a Tax Deferral.

The conclusion of the Court of Appeals that the use of liberalized depreciation results only in a tax deferral is based on its unwarranted assumption that "it is clear that the company would be paying higher taxes in subsequent years than in the test year, * * *" (App., *infra*, p. 11). While it cannot be denied that, where the effect of additions[17] and retirements is ignored, the use of the declining balance method with respect to any single item of depreciable property will result, assuming it is held for its entire life, in higher tax deductions in early years and lower deductions in later years, the court below appears to have overlooked the fact that the "phantom" taxes for a particular tax year arising from the Commission's treatment of liberalized depreciation relate not to any particular asset, but to all the company's assets acquired after December 31, 1953.[18] And for this reason the tax liability for any given year will necessarily depend on the relationship between plant additions and plant retirements.

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[17] The term "additions" is here employed to include not only new acquisitions of plant, but also replacements of assets retired.

For any given year the reserve for "deferred" taxes, which reflects the overstatement of taxes which "normalization" involves, will continue to increase so long as additions exceed retirements, will achieve a plateau if additions equal retirements, and will decrease only where additions and replacements are less in dollar amount than retirements. It is therefore by no means clear that a natural gas company will ever be faced with higher taxes in later years owing to its use of liberalized depreciation.

The assumption that higher taxes in later years will be paid is, in truth, no more than a speculation, and we would say an unrealistic one at that. There is no reason to believe that investment by the natural gas industry in plant will decrease in absolute terms. On the contrary, there is every reason to believe that plant will continue to grow as it has in the past; in this connection, we have already observed the tremendous expansion in the reserve for "deferred" taxes that has already taken place (*supra*, p. 13). In practical effect, therefore, the use of liberalized depreciation results in a tax saving, not a "deferral".[19] In concluding otherwise the court below erred.

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[18] It should be noted in this connection that an income tax is not a tax on property (*Graves v. New York*, 306 U.S. 466, 480-481 (1939)). The tax in question here is applicable to net income and not to property or to any specific items of property.

3. The Assumption by the Court of Appeals That El Paso Would Not Be Entitled to an Adjustment in Its Rates in the Event That It Must Pay Higher Taxes Is Unwarranted.

Based on its unwarranted assumption that the use of liberalized depreciation inevitably brings about higher taxes in future years, the court below proceeded to make an additional assumption, also unwarranted, that El Paso would not be entitled in later years to a rate increase to cover such an increase in taxes. Pursuant to this reasoning, the court approved the Commission's treatment of liberalized depreciation as if "normalization" were to be regarded as a present *adjustment* to cover a future known change in tax expense.

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[19] In *Amere Gas Utilities Company, et al.*, 15 FPC 760, 782 (1956), the Commission itself referred to the tax effect of liberalized depreciation as a "continuing tax deferral". A "continuing tax deferral" extending without limit into the future is, we submit, tantamount to a tax saving. Strictly as a matter of sound regulatory policy, there can be no question that such savings should be reflected in cost of service, and the Commission presumably recognized this fact when it indicated in the *Amere* order that the "traditional method of treating depreciation expense" would be approved in the absence of what it believed to be a countervailing Congressional intent.

It should be observed at this point that the court below rejected the Commission's argument that "normalization" was required in order to carry out the intent of Congress in enacting Section 167 of the Internal Revenue Code (1954), and we think the court's conclusion in this respect was correct. We therefore feel it unnecessary to discuss in this petition the question of Congressional intent insofar as revenue legislation is concerned. For other cases where courts and administrative agencies have rejected the argument for "normalization" based on Congressional intent, see: *City of Pittsburgh v. Pennsylvania Public Utility Commission*, 182 Pa. Super. 551, 128 A.2d 372, 17 PUR 3d 249 (1956); *Central Maine Power Company v. Maine Public Utilities Commission*, 153 Me. 228, 136 A.2d 726, 21 PUR 3d 321 (1957); Interstate Commerce Commission Ruling: *Re Accounting for Federal Income Taxes*, dated February 9, 1959 (24 Fed. Reg. 1401); *Re Niagara Mohawk Power Corporation* (New York Public Service Commission, Nos. 15870, 17818; 28 PUR 3d 171 (1959)); *Re Plainfield-Union Water Company*, 57 NJS 158, 154 A.2d 201 (1959); *Montana-Dakota Utilities Company v. North Dakota Public Service Commission*, 102 N.W. 2d 329, 33 PUR 3d 531 (1960); *Re Tax Treatment of Accelerated Depreciation*, 57 Cal. P.U.C. 598, 33 PUR 3d 209 (1960); *Re Cincinnati Gas and Electric Company* (Ohio Public Utilities Commission, No. 27749, dated October 7, 1960); *City of Alton v. Commerce Commission* (19 Ill. 2d 76, 165 N.E. 2d 513, 33 PUR 3d 76 (1960) "normalization" approved on other grounds).

Adjusting the cost of service in the test year so that it will reflect a *known* prospective change is, of course, a familiar concept in rate making. To fail to do so would be consciously to introduce a distortion in the facts upon which future rates are predicated.[20] It appears that the court below in approving "normalization" believed it was properly following this principle. However, as we have seen, the use of liberalized depreciation does not, as a certainty, bring about future higher taxes; it does not produce a "tax deferral" in a liability sense; it does not produce a "deferral" in a practical sense, unless one is willing to accept the highly speculative, and grossly unrealistic, premise that El Paso will experience an absolute reduction in its plant at some unspecified time in the future. It is therefore incorrect to conclude that liberalized depreciation results in a known change which may properly be made the subject of a present adjustment to the cost of service.

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[20] In this very proceeding, the Commission made various adjustments in the cost of service to cover known changes in expenses which would occur after the end of the test year (R. 165-167). These adjustments reflected increases in costs relative to El Paso's retirement and hospitalization plans, among others, and reflected a decrease in tax expense owing to a reduction in the Texas production tax. The Commission stated: "We agree with the presiding examiner that it is our policy to test rates for the future on the basis of *actual operating experience* of a representative period of time and to adjust that experience for *known* changes." (R. 108; emphasis supplied.)

For example, if it be proper to compel ratepayers to contribute to a reserve now to cover the eventuality of higher taxes accruing in future years, because of the use of liberalized depreciation, then, by the same reasoning, it would appear to be just as proper to require ratepayers to contribute now to a reserve to be used to meet increases in taxes resulting from a possible legislative change in the tax rate. Of course, neither of these prepayments would be consistent with sound rate making principles.

In failing to recognize that a present adjustment in cost of service based on speculative events will bring about a distortion in rates just as much as the failure to take account of known future changes in expense items will have the same effect, the court below erred.

It appears that the Court of Appeals was concerned that El Paso would be unable to correct a deficiency in earnings should its future tax expense increase. The answer to this, we submit, is that El Paso may file for a rate increase to cover any increase in its tax expense or for any other expense, for that matter. The Natural Gas Act affords the company this remedy, and El Paso has in fact filed for such increases on a number of occasions since the inception of this proceeding. In Docket No. G-12948, El Paso has been collecting an annual increase in its rates amounting to $19,550,000 since January 1, 1958. Since August 1, 1959, it has been collecting in increased rates an annual amount of $27,231,000, and on February 23, 1960, in Docket No. RP60-3, El Paso filed an application with the Commission for increased rates, seeking a total increase of $22,085,625. It is therefore clear that El Paso has been provided with a means for correcting earnings deficiencies and it has shown no hesitancy in utilizing this remedy to obtain higher rates.

The argument in support of the position that anticipated later higher taxes should be collected from present ratepayers rests on the unrealistic premise that El Paso will be unable to meet such increases through future rates. Since the decision in *Galveston, supra*, all courts and all regulatory commissions have consistently held that it is the obligation of the ratepayer to pay to the utility rendering service to him the tax liability incurred in connection with such service. This principle, projected into the future, simply means that so long as rate making is predicated upon the certainty of actual costs—including actual tax costs—then, though we do not concede that later higher taxes will follow, such later higher taxes, if they occurred, would be the then actual taxes for which the ratepayer is obligated to make payment to the utility. To assume that any regulatory commission would in the future disregard this obligation is contrary to all precedent to date, both judicial and administrative, and is not only unlikely but, in our opinion, would never occur.

4. Consumers Are Unlawfully Compelled to Make Capital Contributions.

It has heretofore been noted that the reserve for "deferred" taxes represents an allowance for hypothetical taxes which the Commission's treatment of liberalized depreciation requires consumers to provide through rates. Inasmuch as this reserve has accumulated to many millions of dollars and gives every indication of continuing to do so without any end in sight, it is clear that in practical effect the reserve represents involuntary contributions of capital to the utility from ratepayers. This is contrary to the fundamental principle of utility rate making that the utility's stockholders or investors are expected to contribute the capital necessary for the succesful operation of the company, while the consumers of the service are expected to provide through rates a fair and reasonable return on such capital in addition to a sufficient amount to cover the utility's legitimate expenses, including taxes (*Railroad Commission of Louisiana v. Cumberland Telephone & Telegraph Company*, 212 U.S. 414, 424 (1909); *Lindheimer v. Illinois Bell Telephone Company*, 292 U.S. 151, 169 (1934)).

The Commission's treatment, approved by the court below, casts the burden of providing capital on consumers. Referring to the effect of excessive allowances for depreciation expense, this Court said in the *Lindheimer* case (292 U.S. at 169):

> "But if the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers * * * are required to provide, in effect, capital contributions * * * to secure additional plant and equipment upon which the utility expects a return."

The overstatement of tax expe[illegible] and the correlative credit of such overstatement to the reserve also results in a capital contribution. In this connection the Superior Court of Pennsylvania in *City of Pittsburgh v. Pennsylvania Public Utility Commission*, 182 Pa. Super. 551, 128 A.2d 372 (1956), stated (128 A.2d at 385):

> "* * * the result of normalization at best would be to require the present customers to finance plant expansion which may benefit both future customers and the utility; in fact, a capital contribution would then be made by present customers."

It is also to be observed that the natural gas company will expect to earn, through rates, a return on the plant acquired by the investment of the funds represented by the reserve. The ultimate result of the Commission's treatment of liberalized depreciation, therefore, will be to require that consumers pay the utility a return on an investment pro vided by them. In this respect the Commission's treatment, approved by the Court of Appeals, involves a very serious departure from the conventional principles of utility rate making and imposes an unlawful burden on gas consumers.

5. Consumers Are Deprived of the Benefit of Lower Rates.

By reason of the fact that the Commissions' treatment of liberalized depreciation for rate purposes requires consumers to pay, through rates, an amount for a non-existent tax expense, ratepayers are denied lower rates. The Commission's treatment, therefore, is contrary to the basic purpose of the Natural Gas Act which "* * * was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." (*Atlantic Refining Company v. Public Service Commission of New York*, 360 U.S. 378, 388 (1959)).

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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December, 1960.

Appendix

1. Opinion of the Court of Appeals.

OPINION OF THE COURT, FILED: August 2, 1960

In the United States Court of Appeals
for the Fifth Circuit

No. 18022

EL PASO NATURAL GAS COMPANY, *Petitioner*,

versus

FEDERAL POWER COMMISSION, *Respondent*.

No. 18120

SOUTHERN CALIFORNIA GAS COMPANY, and SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA, *Petitioners*,

versus

FEDERAL POWER COMMISSION, *Respondent*.

No. 18124

PACIFIC GAS AND ELECTRIC COMPANY, *Petitioner*,

versus

FEDERAL POWER COMMISSION, *Respondent*.

No. 18125

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners*,

versus

FEDERAL POWER COMMISSION, *Respondent*.

Petitions for Review of an Order of the Federal Power Commission

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(August 2, 1960.)

Before TUTTLE, CAMERON and WISDOM, Circuit Judges.

Tuttle, Circuit Judge: These petitions deal with the proper computation of the rate to be charged to the ultimate consumers of gas, principally residents of the State of California, for the period April 15, 1955-December 31, 1957, for gas produced and transmitted and sold by El Paso Natural Gas Company, an integrated Natural Gas Company.

OPINION

Without expressly identifying the proponent of each separate contention, the principal questions here raised are the treatment to be accorded by the Federal Power Commission in a Section 4 proceeding[1] to certain Federal income tax benefits. The company contends that once the Commission has arrived at a rate that represents the ordinary revenue requirements necessary to reimburse it for all of its operating costs and a reasonable return on its investment, it must fix a rate that will yield this amount and must also permit the company to retain for the benefit of its equity owners the tax savings it achieves from the statutory depletion allowance, from the current deduction of intangible drilling expenses and from use of an optional rapid method of depreciation. The California Commission contends that the parties acquiesced in a 6% return on the entire investment, including the production or well-mouth properties, and that all tax savings must be given effect in arriving at the actual cost of operation; thus all amounts in excess of the sum necessary to return actual costs including a 6% return on the investment must be refunded. Other parties take several intermediate positions. The legal conclusions which we reach will resolve these several contentions without the necessity of separately discussing them all.

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[1] 15 U.S.C.A. §717c provides in material part:

"(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; . . ."

The Commission's order gave effect to the tax savings differing in important respects from the contentions of all of the parties. It held that the 6% rate of return was, in light of acquiescence of all parties, a proper rate of return on the investment before giving consideration to the special circumstances surrounding that part of the investment that represents the ownership of the gas in place and the production facilities. It figured this investment at $74,436,273. It also recognized that special incentives are necessary for the producing end of the integrated business by way of higher return to encourage exploration and drilling of new wells. It equated the special tax savings from depletion and deduction of intangible drilling expense, provided for by Congress as tax benefits in the oil and gas industry, to the ordinary 6% return plus the needed incentive, and allowed the amount represented by these two tax savings to be retained by the company but to be treated as if actually paid in federal taxes. This amount, which represents 8.61% of the $74,436,273 well-mouth investment, was allowed as the return on that investment *in lieu* of the 6% rate, thus making an overall rate of return on the total investment of $549,563,775 for rate making purposes of 6.35%.

The Commission's order also permitted El Paso to take advantage of the rapid depreciation provisions of the 1954 Internal Revenue Code[2] by permitting it to treat its taxes for rate making purposes as though depreciation had been figured on the "straight line" method, but it imposed the requirement that the savings in taxes for the test year be credited to a special reserve account so as to be available for payment of the higher taxes later when the higher depreciation figure could no longer be deducted.

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[2] Section 167 of the Internal Revenue Code of 1954 authorized the taxpayer to take depreciation on newly installed or acquired property on the "declining balance" method, which permits a much larger deduction for tax purposes the first years of the life of such property.

El Paso contends that the requirement that these savings be placed in reserve was invalid and it claimed the privilege of retaining them for its general corporate purposes without restriction. Intervenors contended that only the actual taxes paid under the rapid depreciation schedule should be allowed as operating expenses, and that the company should not be permitted to retain these savings without their being given effect in the rate making process.

All parties present their cases here on the theory that we have an uncomplicated legal question as to how to treat the tax savings benefits which Congress clearly sought to afford either this particular industry or to businesses generally (as to the rapid depreciation option) in the making of just and reasonable rates for the sale of natural gas in interstate commerce.[3]

We have heretofore in *Bel Oil Co. v. Federal Power Commission*, 5 Cir., 255 F. 2d 548, 553, and in *Gulf Oil Corporation v. Federal Power Commission*, 5 Cir., 255 F. 2d 556, 557, stated that the problem of "the regulation of the prices at which thousands of natural gas companies may sell to the pipe line companies is a difficult one at its best," and that the standard of what is a just and reasonable rate "is concededly a difficult standard to specify especially in light of the fact that producers are in reality selling gas that they own and are not, in the traditional sense, primarily furnishing a service to the public." Yet that is precisely the problem with which the Commission had to cope in this case. So far as relates to that element of cost of service that represents the price at which the gas is to be delivered to the transmission lines of El Paso after production is completed the so-called well-mouth investment of El Paso may be viewed as if it were the property of an independent regulated producer. We dealt with such producers in the Bel Oil and associated cases, 255 F. 2d 548, et seq.

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[3] The Commission's brief says:
"This is the first rate case in which the Power Commission has had before it for decision a vigorously contested proceeding involving the effect to be given various deductions authorized by Congress in determining Federal income taxes of companies regulated by the Commission, and uncomplicated by issues respecting the amounts to be included in the company cost of service for company-produced gas."

El Paso contends, the Commission recognizes, and the State of California and other intervenors do not dispute, that in ordinary circumstances the producer is entitled to a rate that permits him to recover his costs and a reasonable return on his investment, which return must include an increment of incentive for exploration and development and compensation for the wasting asset. Here, however, the parties differ widely on what, on the record before us, El Paso is entitled to as representing this increment. El Paso says it is entitled to 6% on the $74,436,273 well-mouth investment, plus $7,704,477, representing savings in taxes for which it should not have to account in computing cost of service. The Commission says it is entitled only to the $7,704,477 tax savings (of which $1,297,717 is to be placed in a reserve as above discussed), representing 8.61% of the well-mouth investment as compared with the 6% rate allowed on the remaining investment.[4] The State of California contends that only the 6% rate of return on the entire investment, including well-mouth, is warranted because it says, "It was stipulated by all parties to the proceeding below, including El Paso, that an allowance for return should be included in the cost of service to provide El Paso with a 6 per cent rate of return on its entire rate base." Other intervenors make this same contention.

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[4] The Commission said in this regard:

"So that the Congressional incentive might not be added to the ordinary rate of return incentive, we were careful in this case to allow the tax incentive as including the ordinary rate of return, for it happened that the tax incentive was greater than the 6 percent return that we would have otherwise permitted upon this record."

While it may be said that all parties participated in the hearing below on the assumption that an overall rate of return of 6% would be applicable, we do not think this forecloses El Paso's right to urge the necessity of fixing a higher rate on the well-mouth investment. This is so because all parties were on notice that El Paso was proceeding on a theory that would have entitled it to realize in addition to the 6% return the tax savings of $7,704,477 by including this item in its cost of service, although it did not actually pay this sum. Thus El Paso was claiming the right to retain the additional sum and we do not think El Paso is bound by its claim for a 6% rate overall if we find the theory by which it sought to obtain its incentive and depletion was the wrong approach.[5]

We thus come to the question: What effect must the Commission give to the tax incentives provided by Congress for the gas industry, as relates to the percentage depletion and intangible drilling expense items and to taxpayers generally, as relates to the rapid depreciation item in arriving at a just and reasonable rate?

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[5] It must be borne in mind that a six percent rate on the overall investment yields much more than that on the equity capital. In a prior determination the Commission had found that the financial structure of El Paso was such that a six percent rate would yield approximately 14.4% on the equity capital of $100,622,000. If our mathematics is correct, the inclusion of an additional $7,704,477 of income would increase this return on the equity capital to approximately 22.1%.

We think that full effect must be given to the Congressional intent to make the several tax savings available to this taxpayer either because it is in the natural gas business or because it is acquiring new equipment subject to the depreciation options of the 1954 Act.

We think, however, that this does not mean that these tax benefits are to be translated into additional profits for the regulated company over and above a reasonable return on its investment. They are available to the regulated companies to make it so much the easier for them, in competition with other fuels and in competition with other industries seeking the investor's dollar to earn a fair return, *including* the substantial increment of incentive for exploration and development and payment for gas consumed.

It has long been held that in rate making and regulation there must be included an item representing depletion of a wasting asset. See *Dayton Power & Light Co. v. Public Utilities Comm. of Ohio*, 292 U.S. 290, and *Columbus Gas Co. v. Utilities Comm. of Ohio*, 292 U.S. 398. In the latter case the Supreme Court said:

> "To withhold from a public utility the privilege of including a depletion allowance among its operating expenses, while confining it to a return of 6½% upon the value of its wasting assets, is to take its property away from it without due process of law, at least where the waste is inevitable and rapid."

It has also been recognized not only by Congress but by the courts as well that there is a public interest in the creation of an incentive to cause additional exploration and development in the oil and natural gas industries. We agree with the statement contained in the opinion of the Commission in this case as to the legislative history showing the Congressional purpose and intent:

"The percentage of income depletion deduction has had a long history which indicates that it is designed to encourage the exploration for and the development of oil and gas properties. The Revenue Act of 1916 (39 Stat. 756, 759), which first recognized the depletion of oil and gas, required the use of cost or value as of March 1, 1913, as a basis for depletion. With the Revenue Act of 1918 a change was made so as to allow depletion based upon the fair market value of the property at the date of the discovery known as 'discovery depletion' (40 Stat. 1057, 1068). The legislative history of this Act emphasizes the hazards of the industry and the need for incentives to prevent the end of prospecting and wildcatting, 56 Cong. Rec. 10339, 10539-10542. The 'discovery depletion' provision was reenacted in the 1924 Act (43 Stat. 253, 260) with the recognition of the large risks in the oil and gas business, 65 Cong. Rec. 2429. In the Revenue Act of 1926 (44 Stat. 9, 16) 'percentage depletion' at 27½ percent was introduced to avoid some of the administrative difficulties of 'discovery depletion' (S. Rep. 52, 69th Cong., 1st Session, pp. 17-18; 67 Cong. Rec. 3018-3019). It was noted by the House Ways and Means Committee in reporting the 1926 bill, that the purpose of discovery depletion was to encourage the wildcatter or pioneer (H. Rep. No. 1, 69th Cong. 1st Session, p. 6). In connection with the 1934 Revenue Act (48 Stat. 680, 710) the peculiar risks and hazardous character of the industry were recognized (78th Cong. Rec. 6181-6183)."

The most recent statement of the Supreme Court as to the purpose of percentage depletion is in *United States v. Cannelton Sewer Pipe Co.*, No. 513, October Term, 1959, 28 L. W. 4602:

"In summary, mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets. Anderson v. Helvering, 310 U.S. 404 (1940). In addition, it is based on the belief that its allowance

> encourages extensive exploration and increasing discoveries of additional minerals to the benefit of the economy and strength of the Nation . . . ."

El Paso contends that this policy means that it is entitled to keep the tax benefits thus granted to it as a gas producer over and above an amount charged for its gas that would represent a reasonable return on its investment. We hold that this does not follow. It is manifestly the intent of Congress that the sale of natural gas in interstate commerce shall be regulated in such manner as to prevent prices to be charged that are not just and reasonable rates. However, as we have stated, such reasonable rate must include an increment representing compensation for the depletion of the gas supply. *Dayton Power & Light Co. v. Public Utilities Comm. of Ohio, supra.* Traditionally, also, reasonable return has always included an increment to attract capital to the venture. In the gas industry this is the incentive item we have discussed above. See *City of Detroit v. F.P.C.*, D.C.Cir., 230 F. 2d 810. The requirement that the Commission determine a just and reasonable rate is not modified by reading into the statute an exception to the extent that the prices charged may be sufficient to afford a just and reasonable rate *plus* an amount representing a savings in taxes granted to the gas industry. We think there is nothing in the legislative history that would warrant our concluding that Congress intended the statutory depletion, deduction of intangible drilling expense, and rapid depreciation provisions of the Revenue laws to amend or modify the express language of the Natural Gas Act, which provides:

> "§717d. Fixing rates and charges; determination of cost of production or transportation.
>
> (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State,

> municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: Provided, however, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates." 15 U.S.C.A. §717d.

We think, in short, that there is no statutory authority for the Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation.

What we have here concluded does not, of course, reach the question: What is the just and reasonable rate to be charged? It may be that what the Commission set as a jus-

and reasonable rate as to the well-mouth properties is the correct figure, but there is nothing in the record to support it, and the rationale by which the Commission arrived at the figure of 8.35% we have seen to be incorrect. It is the duty of the Commission to fix a rate that represents the cost of service and a reasonable return on the investment, including compensation for consumption of the gas and an increment for incentive, instead of merely *treating* the tax savings as the amount necessary to provide for return and incentive. This can be done only by making the necessary inquiry directed to this issue, building up a proper record, and making findings on the amount *actually necessary* to provide these items.

We conclude that the two true tax savings are to be treated alike. Other than the depreciation item, whatever federal income taxes were actually paid for the test year should be treated as part of the cost of service regardless of whether these taxes were less than would have been paid but for the depletion allowance and the deduction for intangible drilling expense. No theoretical amount not actually paid can be so included.

The one exception, if it be an exception, is the treatment to be afforded the tax saving or deferral resulting from the use by the taxpayer of the declining balance method of depreciation of new equipment. In practical effect this works a tax deferral rather than a tax savings. If the company were charged for rate making purposes with such "savings" during the year in which the depreciable assets were acquired, and the rate resulting from such treatment of the taxes was thereafter used for later years, as is here the case, it is clear that the company would be paying higher taxes in subsequent years than in the test year, but would not be entitled to an adjustment in rates to cover the increase.

Therefore, we approve the Commission's treatment of the "saving" resulting from using the declining balance method of depreciation for tax purposes but computing its taxes for rate making purposes on the straight line method of depreciation, placing such "savings" in a special reserve to be used to equalize tax payments in later years. These amounts can never represent added return to the company because of the restriction as to their use.

Nothing here decided prevents the Commission from giving consideration to the legislative history which resulted in these tax benefits as an aid to it in determining what figure must be used to assure the petitioner of a sufficient rate to compensate it for its depletion of gas and as an incentive to attract capital to this industry.[6]

The State of California and other intervenors contend that, though the year 1955 was accepted as a test year, evidence should be adduced to show that actual revenues for 1956 and 1957 exceeded those anticipated, and that the refunds should be in accord with the actual experience rather than with the test year. We think that in the interest of orderly administration it was within the power of the Commission to decline to open the hearings for a showing of the actual costs of services and the revenues for the years following the end of the hearings before the examiner. All parties accepted the year 1955 as the test year and we think it was not an abuse of discretion for the Commission to refuse to reopen the proceedings for such showing.

In order that the Commission may give effect to the Federal income tax savings and fix a just and reasonable rate in light of what has been said here, the petitions are granted and the cause is remanded to the Commission. Upon such remand the Commission will receive such evidence as may be necessary to enable it to fix a just and reasonable rate to permit a fair return on the well-mouth investment and provide the incentive necessary to attract capital to the exploration and development activities of the company.

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[6] It is not clear from the record, since the point was not argued whether the cost of service given effect by the Commission's order includes amortization of a figure representing the gas in place. Of course, if it does, then to that extent the item of compensation for gas consumed has been taken care of.

2. Judgment of the Court of Appeals.

In the United States Court of Appeals
for the Fifth Circuit

Original Filed: August 2, 1960.

OCTOBER TERM, 1959

No. 18022

EL PASO NATURAL GAS COMPANY, *Petitioner,*
versus
FEDERAL POWER COMMISSION, *Respondent.*

No. 18120

SOUTHERN CALIFORNIA GAS COMPANY, and SOUTHERN COUNTIES GAS COMPANY OF CALIFORNIA, *Petitioners,*
versus
FEDERAL POWER COMMISSION, *Respondent.*

No. 18124

PACIFIC GAS AND ELECTRIC COMPANY, *Petitioner,*
versus
FEDERAL POWER COMMISSION, *Respondent,*

No. 18125

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners,*
versus
FEDERAL POWER COMMISSION, *Respondent.*

Petitions for Review of an Order of the Federal Power Commission

Before TUTTLE, CAMERON and WISDOM, Circuit Judges.

JUDGMENT

These causes came on to be heard on the petitions filed by El Paso Natural Gas Company, Southern California Gas Company, Southern Counties Gas Company, Pacific Gas Electric Company, People of the State of California and Public Utilities Commission of the State of California, for review of an order of the Federal Power Commission issued on August 10, 1959 in Docket No. G-4769, and was argued by counsel:

On Consideration Whereof, It is now here ordered, adjudged and decreed by this Court that, in order that the Commission may give effect to the Federal income tax savings and fix a just and reasonable rate in light of what has been said in the opinion of this Court, the petitions for review in this cause be, and they are hereby, granted: and that the cause be remanded to the Commission. Upon such remand the Commission will receive such evidence as may be necessary to enable it to fix a just and reasonable rate to permit a fair return on the well-mouth investment and provide the incentive necessary to attract capital to the exploration and development activities of the company.

August 2, 1960

Issued: October 13, 1960

3. Order of the Court of Appeals Denying Rehearing.

In the United States Court of Appeals
for the Fifth Circuit

No. 18125

PEOPLE OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *Petitioners*,

versus

FEDERAL POWER COMMISSION, *Respondent*.

Petition for Review of an Order of the Federal Power Commission

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(September 30, 1960)

ON PETITION FOR REHEARING

Before TUTTLE, CAMERON and WISDOM, Circuit Judges.
Per Curiam:

IT IS ORDERED that the petition for Rehearing filed in the above styled and numbered cause be, and the same is hereby DENIED.

Original Filed: September 30, 1960.

4. Pertinent Text of Statutes Involved.

a. The pertinent provisions of the Natural Gas Act are as follows:

Section 4 [52 Stat. 822; 15 U.S.C. 717c]:

(a) "All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful."

* * * * * * *

(d) "Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published."

(e) "Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 15 U.S.C. §717c]"

Section 5 [52 Stat. 823; 15 U.S.C. 717d]:

(a) "Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charge, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates."

b. The pertinent provisions of the Internal Revenue Code of 1954 are as follows:

Section 167 [68A Stat. 51, amended, 71 Stat. 414 and 72 Stat. 1608; 26 U.S.C. 167]:

(a) "*General rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income."

(b) "*Use of certain methods and rates.*—For taxable years ending after December 31, 1953, the term 'reasonable allowance' as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2). Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a)."

(c) "*Limitations on use of certain methods and rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

(1) the construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or

(2) acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date."

* * * * * * *

(e) "*Change in method.*—In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b) (2) to the method described in subsection (b) (1)."

Section 168 [68A Stat. 52, as amended, 71 Stat. 414 and 72 Stat. 1608; 26 U.S.C. 168]:

(a) "*General rule.*—Every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of any emergency facility (as defined in subsection (d)), based on a period of 60 months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such adjusted basis at the end of the month shall be computed without regard to the amortization deduction for such month. The amortization deduction above provided with respect to any month shall, except to the extent provided in subsection (f), be in lieu of the depreciation deduction with respect to such facility for such month provided by section 167. The 60-month period shall begin as to any emergency facility, at the election of the taxpayer, with the month following the month in which the facility was completed or acquired, or with the succeeding taxable year."

* * * * * * *

(d) "Definitions.—

(1) *Emergency facility.*—For purposes of this section, the term 'emergency facility' means any facility, land, building, machinery, or equipment, or any part thereof, the construction, reconstruction, erection, installation, or acquisition of which was completed after December 31, 1949, and with respect to which a certificate under subsection (e) has been made. In no event shall an amortization deduction be allowed in respect of any emergency facility for any taxable year unless a certificate in respect thereof under this paragraph shall have been made before the filing of the taxpayer's return for such taxable year.

(2) *Emergency period.*—For purposes of this section, the term 'emergency period' means the period beginning January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the emergency facilities with respect to which certifications under subsection (e) have been made is no longer required in the interest of national defense."

(e) "*Determination of adjusted basis of emergency facility.*—In determining, for purposes of subsection (a) or (g), the adjusted basis of an emergency facility—

(1) *Certifications on or before August 22, 1957.*—In the case of a certificate made on or before August 22, 1957, there shall be included only so much of the amount of the adjusted basis of such facility (computed without regard to this section) as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1949, as the certifying authority, designated by the President by Executive Order, has certified as necessary in the interest of national defense during the emergency period, and only such portion of such amount as such authority has certified as attributable to defense pur-

poses. Such certification shall be under such regulations as may be prescribed from time to time by such certifying authority with the approval of the President. An application for a certificate must be filed at such time and in such manner as may be prescribed by such certifying authority under such regulations, but in no event shall such certificate have any effect unless an application therefor is filed before March 24, 1951, or before the expiration of 6 months after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition, whichever is later.

(2) *Certifications after August 22, 1957.*—In the case of a certificate made after August 22, 1957, there shall be included only so much of the amount of the adjusted basis of such facility (computed without regard to this section) as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1949, as the certifying authority designated by the President by Executive order, has certified is to be used—

(A) to produce new or specialized defense items or components of new or specialized defense items (as defined in paragraph (4)) during the emergency period,

(B) to provide research, developmental, or experimental services during the emergency period for the Department of Defense (or one of the component departments of such Department), or for the Atomic Energy Commission, as a part of the national defense program, or

(C) to provide primary processing for uranium ore or uranium concentrate under a program of the Atomic Energy Commission for the development of new sources of uranium ore or uranium concentrate, and only such portion of such amount as such authority has certified is attributable to the national defense program. Such certification shall be under such regulations as may be prescribed from time to time by such certifying authority with the approval of the President. An application for a certificate must be filed at such time and in such manner as may be prescribed by such certifying authority under such regulations but in no event shall such certificate have any effect unless an application therefor is filed before the expiration of 6 months after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition. For purposes of the preceding sentence, an application which was timely filed under this subsection on or before August 22, 1957, and which was pending on such date, shall be considered to be an application timely filed under this paragraph.

(3) *Separate facilities; special rule.*—After the completion or acquisition of any emergency facility with respect to which a certificate under paragraph (1) or (2) has been made, any expenditure (attributable to such facility and to the period after such completion or acquisition) which does not represent construction, reconstruction, erection, installation, or acquisition included in such certificate, but with respect to which a separate certificate is made under paragraph (1) or (2), shall not be applied in adjustment of the basis of such facility, but a separate basis shall be computed therefor pursuant to paragraph (1) or (2), as the case may be, as if it were a new and separate emergency facility.

(4) *Definitions.*—For purposes of paragraph (2)—

(A) *New or specialized defense item.*—The term 'new or specialized defense item' means only an item (excluding services)—

(i) which is produced, or will be produced, for sale to the Department of Defense (or one of the component departments of such Department), or to the Atomic Energy Commission, for use in the national defense program, and

(ii) for the production of which existing productive facilities are unsuitable because of its newness or of its specialized defense features.

(B) *Component of new or specialized defense item.*—The term 'component of a new or specialized defense item' means only an item—

(i) which is, or will become, a physical part of a new or specialized defense item, and

(ii) for the production of which existing productive facilities are unsuitable because of its newness or of its specialized defense features.

(5) *Limitation with respect to uranium ore or uranium concentrate processing facilities.*—No certificate shall be made under paragraph (2) (C) with respect to any facility unless existing facilities for processing the uranium ore or uranium concentrate which will be processed by such facility are unsuitable because of their location."

* * * * * * *

(i) "*Termination.*—No certificate under subsection (e) shall be made with respect to any emergency facility after December 31, 1959."

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Office-Supreme Court, U.S.
FILED
FEB. 23 1961
JAMES R. BROWNING, Clerk

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960

No. 599

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF AMICI CURIAE OF THE COMMONWEALTH OF PENNSYLVANIA AND THE PENNSYLVANIA PUBLIC UTILITY COMMISSION, AND THE CITIES OF PITTSBURGH, PENNSYLVANIA, CINCINNATI, COLUMBUS AND HAMILTON, OHIO.

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OCTOBER TERM, 1960

No. 599

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF AMICI CURIAE OF THE COMMONWEALTH OF PENNSYLVANIA AND THE PENNSYLVANIA PUBLIC UTILITY COMMISSION, AND THE CITIES OF PITTSBURGH, PENNSYLVANIA, CINCINNATI, COLUMBUS AND HAMILTON, OHIO.

Interest of Amici Curiae

Interest Identified

The Commonwealth of Pennsylvania and the Pennsylvania Public Utility Commission, an agency of the Commonwealth (hereinafter referred to as Pennsylvania), and the Cities of Pittsburgh, Pennsylvania, and Cincinnati, Columbus, and Hamilton, Ohio (hereinafter referred to as the Cities), political subdivisions of their respective states, file this brief pursuant to Rule 42(4) of the rules of this Court, urging the Court to review the decision below (reported at 281 F. 2nd 567). This brief is sponsored by the authorized law officers of Pennsylvania and the Cities.

Pennsylvania and the Cities, along with other state and municipal agencies, as consumers of natural gas and as representatives of consumers, have appeared before the Federal Power Commission (Commission) in many pending proceedings where the treatment of accelerated or liberalized depreciation is the subject of contest by them. It was, therefore, a distinct shock for Pennsylvania and the Cities to learn, very recently, that El Paso Natural Gas Company (El Paso), through its attorneys, in a brief in opposition to the petition for certiorari purports to inform the Court that:

> "The issue presented by the petition is of little importance on this record, and of even less beyond it. We know of no litigant before the Commission, except California PUC, which has refused to accept the Commission's decision on liberalized depreciation. . . . Except to California PUC, the question it presents is a dead issue, and has been ever since the Court of Appeals' *City of Detroit* decision five years ago." Brief in Op. of El Paso, p. 12.

We think this is an unwarranted attempt to lead the Court to believe that a matter of small consequence and no future importance, beneath the Court's notice, has been brought to its attention. Nothing could be further from the truth.

The Spread of the Problem

There are literally dozens of pipelines rate cases pending before the Federal Power Commission in which the charging of fictional taxes, as a result of the erroneous treatment of accelerated depreciation permitted by the Commission in establishing rates, is a major issue. One of these is now awaiting decision by the United States Court of Appeals for the Fourth Circuit (*City of Lexington et al.* v. *Federal Power Commission*, No. 8101). In that case, involving the rates of United Fuel Gas Company, a group of Kentucky Cities are the petitioners who brought the matter to the Fourth Circuit in May 1960 following a long contest over several years before the Commission.

The issue of "normalizing" taxes, notwithstanding the savings achieved from liberalized depreciation deductions under § 167 of the Internal Revenue Code, has become so intense and widespread that in a half dozen or more cases which were otherwise ready for settlement, the Commission has approved settlements subject to a reservation that if on ultimate judicial determination in the *City of Lexington* case (or similarly phrased) the Commission's order with respect to liberalized depreciation is held to be erroneous, further proceedings may be had in those dockets upon motion of any party. By name, some which in recent months have been settled with such a reservation are:

Transcontinental Gas Pipe Line Corporation, Docket No. G-18783

Texas Eastern Transmission Corporation Docket Nos. G-12706, G-18841

United Fuel Gas Company, Docket Nos. G-12195, G-16316, G-16815, G-18420.

Kentucky Gas Transmission Corporation, Docket Nos. G-12199, G-16816, G-18421.

Atlantic Seaboard Corporation, Docket Nos. G-12196, G-16817, G-18422, G-19326.

In still other cases where this matter of fictional taxes is a major issue, hearings have been held, or are in process of being held, or have not yet been reached for hearing. Some of these are:

Southern Natural Gas Company, Docket Nos. G-2509, and RP 60-15

Tennessee Gas Transmission Company, Docket Nos. G-11980, G-17166, G-19983

Panhandle Eastern Pipeline Company, Docket No. G-19780

Alabama-Tennessee Gas Company, Docket Nos. G-5471, G-11982, G-17218, and G-19984

Columbia Gas Transmission Company, Docket No. G-20241

New York State Natural Gas Company, Docket Nos. G-17296, G-19087, and G-20109.

The Significance of the Issue

Most pipeline companies take accelerated depreciation in computing their income taxes and do not pass the resulting savings through to their customers except in the rare instances where some few of their operations are subject to a local jurisdiction which may compel the pass-through.

At the end of 1959, the Federal Power Commission's Statistics of Natural Gas Companies showed that the pipeline companies had accumulated for alleged deferred taxes almost $190 million, the major portion of which resulted from accelerated depreciation. In the case of electric utilities, the Commission's Statistics of Electric Utilities showed over $1 billion accumulated for alleged deferred taxes, a large part of which resulted from accelerated depreciation. One writer on the subject has said "Over the next 20 years liberalized depreciation could hand the power companies a whopping $13 billion in tax savings with ultimate possible benefits to the power companies of as much as $47 billion . . . Federal Power Commission statistics show that in 1958, private power companies kept an average of 20 percent of every dollar they collected from their customers, allegedly to cover the companies' Federal income taxes." J. D. Brown, Public Power Magazine, Feb. 1960 reprinted in 106 Cong. Rec. A-2121 (daily ed. Mar. 10, 1960).

These excess revenues are derived from unnecessarily higher rates to consumers, collected as an alleged tax expense for which the companies are not liable and which they are not paying as taxes. The result is a gouging of consumers in spite of this Court's decisions in the *Hope* and *Catco* cases.

In *Hope* (*FPC* v. *Hope Natural Gas Company*, 320 U.S. 591, 612), the Court said that the Natural Gas Act's primary purpose is "to protect the consumer interests against exploitation at the hands of private natural gas companies"; and said more recently in *Catco* (*Atlantic Refining Company* v. *P.S. Commission*, 360 U.S. 378, 388) that it was "the intention of Congress that natural gas shall be sold in interstate commerce for resale for ultimate public consumption . . . at the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest."

The painstaking efforts of the regulatory commissions of twenty states (Arizona, California, Colorado, Connecticut, District of Columbia, Idaho, Maine, Missouri, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Vermont, Washington and West Virginia) and of their state courts (see post) to supplement the policy of the Natural Gas Act and assist in achieving the lowest possible reasonable rates by insisting that the tax savings from accelerated depreciation flow through to the consumers will be put to nought if the holding of the Fifth Circuit becomes law, and is not reversed by this Court.[1]

ARGUMENT

Administrative Agency Expertise Not Involved

This is a novel matter of great importance not yet passed upon by the Court which should be settled by it. It should be observed that the crucial question for decision in this case is not a matter that lies within the expertise or even discretion of the Federal Power Commission. That question is the meaning of the federal tax law, section 167 Internal Revenue Code, in relation to the Natural Gas Act. This is a question of law. It was erroneously decided in the first instance by the Federal Power Commission on a ground which the Fifth Circuit did not accept. But the Fifth Circuit perpetuated the error because it acted on two assumptions without proof, if not contrary to the proof.

---

[1] A number of federal agencies have not agreed with the Federal Power Commission's view of section 167. The General Services Administration in a brief on behalf of the United States dated September 1, 1959, urged the California Commission, the petitioner in this case, to adopt a method of flow-through to the consumers of tax savings from accelerated depreciation; and the California Commission adopted those views and rejected "normalization". *Re Tax Treatment of Accelerated Depreciation*, No. 6148, Cal. PUC, April 12, 1960, 33 PUR 3d 209.

The Interstate Commerce Commission ruling of February 9, 1959, 24 Fed. Reg. 1401, rejects normalization and permits charging of only current tax needs.

How Problem Arose

The problem has arisen in this way. The company, El Paso, has been using a form of accelerated or liberalized depreciation authorized by section 167 of the Internal Revenue Code, which provides a greater rate of depreciation in the early life of an item of depreciated property as contrasted with a lesser rate in its later life. This has given El Paso a larger depreciation deduction for income tax purposes than would have been the case if it had continued to calculate its depreciation on a straight-line basis, i.e., at an even rate for each year of the life of the property. The result of these larger depreciation deductions has been reductions in income tax payments.

Nevertheless, El Paso has added to its cost of service and claimed for rate making purposes, amounts greater than the actual taxes paid, by the fiction of computing the taxes as though it had claimed only straight-line depreciation deductions for tax purposes. The effect is to charge higher rates than would be the case if only the true tax expenses were included in the cost of service.

The Error—Two Assumptions Made

The Commission said this departure from its usual rules regarding tax expense was all right because Congress had intended to give the pipeline companies a special benefit. Therefore, the companies were entitled to keep the tax reductions achieved.

The Fifth Circuit said the Commission was mistaken in this regard and that Congress had not intended any express or implied repeal of the Natural Gas Act in its rate making processes. Hence any tax savings were to be passed on to the pipeline customers, as are other savings realized in pipeline operations. In this the Court was right.

However, the Court went on to make two assumptions. These were, first, that the company would clearly be paying higher taxes in later years because of the use of accelerated depreciation, and second, that the company could not get an adjustment of rates to meet the increase. Hence, it said, there was merely a deferment of taxes for which the company was entitled to collect now in its rates.

Neither Assumption Is Supportable And If One Fails The Result Is Altered

If either assumption should fall, the Court's basis for decision falls. Parenthetically, it is interesting to observe that the Commission never said either of the two things postulated by the Fifth Circuit. As noted above, the Commission had relied principally on the special-benefit-for-the-pipeline-company theory, which the Court below rightly knocked out. The Commission majority used a deferment argument, not as a certainty, but with the thought that it was not prepared to predict that there would be continual expansion of facilities each year so that there would be constantly increasing tax reductions. And, of course, it never asserted that a pipeline company could not get an adjustment of rates in the future to meet future increases of costs, including taxes. (In fact, in its brief in the Fourth Circuit in the pending *City of Lexington* case, supra, it has stated what has always been the law and practice before the Commission, "If taxes rise, the utility is entitled to rates which yield a fair return at the new level of taxes". Brief Oct. 10, 1960, p. 17)

On the merits of a deferral versus tax savings, we think there is ample in the record of the case to show that the mistaken notion that the tax reduction from use of accelerated depreciation is a "deferral" results from restricting attention to a single piece of property. From the evidence, largely ignored since the beginning because of the Commission's erroneous interpretation of legislative history, it is more likely that the company will be paying less in taxes on account of its use of accelerated depreciation, and will clearly not be paying more than would result from use of straight-line depreciation.

But even if this should ultimately prove not to be true, the feared increase is at a time twenty or more years hence and it is clear that an increase in future taxes is within the scope of a normal rate increase proceeding, as in the case of any other increase in cost of service. The multitude of past and pending rate increase proceedings before the Commission is mute yet eloquent testimony on what happens to rates when increases occur in many kinds of costs, including taxes.

Other Courts And Agencies Disagree With Court Below

It is useful to recount that so far no other court has taken the view adopted by the Fifth Circuit, which was the first federal court to consider the matter. All of the state courts which have considered the question have held against charging normalized rather than actual taxes, *Pittsburgh* v. *Pennsylvania PUC*, 182 Pa. Super 551, 128 A2d 372 (1956); *Central Maine Power Co.* v. *Public Utilities Comm'n*, 153 Me. 228, 247-248, 136 A.2d 726 (1957); *Montana-Dakota Utilities Co.* v. *North Dakota P.S. Comm'n*, 102 N.W. 2d 329 (N.D. 1960); *In Re Plainfield Water Co.*, 57 N.J. Super. 158, 154 A.2d 201 (1959); except in the case of *City of Alton* v. *Commerce Commission*, 19 Ill. 2nd 76, 165 N.E. 2nd 513 (1960), but here the Court recognized the unfairness in normalization to consumers by requiring that funds generated by accruing deferred tax expenses and any facilities financed out of these funds must be excluded from the rate base.

El Paso also conveniently overlooks the fact (see page 12, footnote 14, of its brief in opposition) that some twenty state commissions (listed above) have, in careful opinions, many after thorough hearings and scrutiny of the problem, found there is no tax deferment and have provided that the tax savings should flow through to the customers and consumers. These decisions have not been based on any special state law or policy, but rest on the examination of the legislative history and meaning of § 167 of the Internal Revenue Code in determining federal income tax costs for cost of service in rate making. The Interstate Commerce Commission and the General Services Administration likewise insist on the passing of the tax savings to customers and oppose "normalization" (see footnote 1, supra).

Congressional View—No Deferment

In this connection it is interesting to note that Congress in enacting § 167 of the Internal Revenue Code did not expect that the Treasury would regain from the property depreciated the taxes lost at the start. Both the majority and minority of the House Ways and Means Committee agreed that the Treasury would suffer an immediate loss in the first year, 1954, and succeedingly increased losses in the years to follow. Both agreed that the losses could not be made up in future years from the same property which was depreciated under the accelerated method beginning in 1954. They disagreed only in whether the loss in revenue would be made up in some way. The majority thought the losses would be made up within the next few years because the stimulus of the new formula would produce "a volume of additional investments and taxable income", H.R. Report 1337, 83d Cong. p. 9.

The minority thought the losses would mount to a peak in 1960 of $2.200 billion, and not level out to a point of equilibrium until eighteen years from 1954 (1972). But before this point was reached there would be a $19 billion "irretrievable loss" in revenue, Id. p. 17.

Under both views it is clear that Congress did not expect the initially depreciated property to be the source of a return of the revenue lost.

FPC Has Unlawfully Delegated Any Responsibility It May Have To Companies

The question of whether there is a tax saving or tax deferment is basically a question of interpreting the federal tax law and the result it produces. Once that decision is made, the Federal Power Commission would apply it in the determination of the cost of service in ratemaking under the usual processes of the Natural Gas Act.

But, if it is to be argued and assumed that the treatment of the tax reductions from accelerated depreciation is a matter within the discretion of the Federal Power Commission, it is quite clear that the Commission has not accepted that responsibility, but has in fact delegated it unlawfully to the pipeline companies. This is so because the policy enunciated in FPC Order No. 203, 19 FPC 826 (1958) is purely optional with the companies taking liberalized depreciation. (No. 203 is for natural gas companies, and the same is true under Order No. 204, 19 FPC 837, for electric companies.) Thus, the company may either normalize the taxes, or its may pass the tax savings through to its customers. Only if it normalizes the taxes is it obliged to set up the so-called reserve account. If there were a genuine belief that there is a true deferment of taxes and that future ratepayers will be unfairly charged for amounts that ought to be charged to current ratepayers, the governmental policy respecting normalization should and would be mandatory. But there is no such firm belief, and there cannot be such in the light of what has developed so far since 1954.

The result is that whether ratepayers are charged more or less, because of the use and treatment of accelerated depreciation is left up to the companies. Any alleged discretion of the Commission has been unlawfully placed in the hands of the companies.

The Case Involving Accelerated Amortization Under Section 168 Does Not Govern This Case.

El Paso purports to inform this court that the *City of Detroit* v. *FPC*, 230 F. 2nd 810, cert. den. 352 U.S. 839, decided the issue in this case (Brief in Op. pp. 5, 8, 10, 11, 12). On the contrary, that case dealt with the five year amortization of emergency defense facilities under § 168 of the Internal Revenue Code, which is quite a different matter from the general depreciation provisions of section 167 applicable over the normal life of all depreciable property in the hands of all taxpayers. There the District of Columbia Circuit found specifically that under section 168 a special benefit for the companies constructing emergency defense facilities was intended for them, to be retained by them, as compensation for the special effort and risk. Here the Fifth Circuit correctly rejected the idea that under section 167 there was any such special benefit intended for regulated pipelines, whose usual risks and incentives are dealt with under regulation of their ratemaking, and whose profits are to be derived from a fair return on the capital invested.

The Result Here Nullifies The Established Principles Of Ratemaking

El Paso is a regulated utility. It enjoys a form of monopoly in its service area. The rates for its product and services are prescribed under governmental authority. These rates assure it of reimbursement for all costs and a fair return or profit on its net investment. There is nothing unfair or unusual in expecting that these costs be the actual immediate needs rather than some future costs which might or might not materialize twenty or more years hence. To permit El Paso, or any other pipeline, to collect in rates tax costs greater than actual tax needs, is to reverse the established regulatory concept that the shareholders and investors, and not the consumers, furnish the necessary capital for operation of the business. Consumers should not be required to make interest free loans or permanent contributions to the capital funds of natural gas pipelines, or any other regulated utility; nor should the consumers be required to pay an additional rate of return on these capital funds forced from them. The device of normalizing taxes to ignore the savings provided by the tax law results in higher rates, and denies the required credit in the form of lower rates.

As the Fifth Circuit correctly said, "There is no statutory authority for the Commission to treat actual savings in taxes differently than savings in any other cost of service".

CONCLUSION

We respectfully urge that the Court grant the petition of the State of California and the Public Utilities Commission of California for a writ of certiorari.

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No. 599

In the Supreme Court of the United States

OCTOBER TERM, 1960

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
PETITIONERS

v.

FEDERAL POWER COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 599

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, PETITIONERS

v.

FEDERAL POWER COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

OPINIONS BELOW

The orders of the Federal Power Commission (R. 104–163, 201–218)[1] are reported at 22 F.P.C. 260 and 659. The opinion of the court of appeals (Pet. App. 1–13) is reported at 281 F. 2d 567.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 1960 (Pet. App. 14–15). A timely petition for rehearing was denied on September 30, 1960 (Pet. App. 16). The petition for a writ of certiorari was filed on December 23, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

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[1] "R." refers to the joint appendix filed in the court of appeals.

QUESTION PRESENTED

Whether, in determining under the Natural Gas Act the just and reasonable rates to be charged by a natural-gas company, the Federal Power Commission had power to treat the tax benefits, resulting from the company's use of the "liberalized depreciation" provisions of Section 167 of the Internal Revenue Code of 1954, as deferred income taxes to be credited to, and held in, a reserve account for use in subsequent years to defray offsetting tax increases anticipated in those years, and as a proper charge to the company's annual cost of service.

STATUTES INVOLVED

Sections 4 (a) and (e), 5(a) and 8(a) of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717c (a) and (e), 717d(a) and 717g(a), are set forth in the Appendix, *infra,* pp. 20-22.

STATEMENT

Petitioners intervened in a proceeding before the Federal Power Commission for the determination of just and reasonable rates to be charged by El Paso Natural Gas Company, an integrated natural gas company, for wholesale sales of gas to certain distributors serving customers in the States of Arizona, California, New Mexico and Texas (R. 104). There were eight other intervenors,[2] three of whom, in addition to petitioners and El Paso, sought review in the court of appeals; only petitioners' appeal was addressed to the particular question raised by this petition. The court below affirmed the Commission's order in this and other respects, but remanded on one issue.

1. *Proceedings before the Commission.* The Commission proceeding was instituted by an order issued November 15, 1954, in Docket No. G-4769, providing for a hearing on proposed increased rates filed by El Paso, and suspending the effectiveness of the increased rates for the statutory maximum of five months until April 15, 1955, at which time they became effective subject to refund. These rates remained in effect until January 1, 1958, when further increased rates, not here questioned, became effective, subject to refund.[3] Hearings were held commencing July 11, 1956, and concluding December 12, 1956. The Examiner issued his decision March 20, 1958, and

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[2] Pacific Gas and Electric Company, Southern California Gas Company, Southern Counties Gas Company of California, City of Los Angeles, Southern Union Gas Company, Nevada Natural Gas Pipe Line Company, San Diego Gas and Electric Company, and New Mexico Public Service Commission (R. 106).

[3] The particular rates here in issue therefore have no present or future applicability.

exceptions were taken by all intervenors and Commission staff counsel (R. 104–105). After oral argument the Commission's opinion and order fixing rates and providing for refund was issued on August 10, 1959 (R. 104–163).

In determining the just and reasonable rates, the Commission followed the traditional rate base method, using a calculated cost of service for the accepted test year 1955. Numerous questions relating to El Paso's cost of service and to its design of rates were raised and decided, and one is to be decided on remand from the court of appeals. The only issue presented by this petition, however, concerns the Commission's treatment, for rate making purposes, of the tax deduction for "liberalized depreciation" permitted by Section 167 of the Internal Revenue Code of 1954, in computing the amount representing federal income taxes to be included in El Paso's cost of service.

The Commission determined that El Paso's election to compute depreciation for tax purposes on the basis of the declining balance method (as permitted by Section 167), in lieu of the straight-line method, resulted not in a tax saving but in a tax deferral. The amount of the deferral was required to be credited to, and retained by, El Paso in a special reserve account against which charges would be made in subsequent years when the taxes so deferred would potentially have to be paid. Accordingly, in calculating El Paso's cost of service, the Commission "normalized" taxes by including an amount for income taxes based on the use of straight-line depreciation.[4] The difference between this amount and the smaller amount calculated on the basis of the larger deductions permitted by the declining balance method constituted the amount to be credited to the reserve.[5]

Maintaining that this determination by the Commission, among others, was unlawful, petitioners applied for rehearing (R. 164–166). The application was denied in an opinion and order issued October 8, 1959 (R. 201–218).[6]

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[4] The Commission observed that the normalization of taxes did not require the Commission to make any adjustment in El Paso's rate of return since the parties had "accepted 6 per cent as the appropriate rate of return" (R. 116). The Commission pointed out, however, that "in another proceeding it might be shown that the reserves accumulated * * * would have an actual and favorable effect on the company's cost of money, and this effect might lead us to consider whether to reflect this tendency in determining a fair rate of return" (R. 116).

[5] As found by the Commission (R. 129), El Paso's federal income taxes for the test year figured on straight-line depreciation were $8,274,090, broken down as follows:

Federal income tax payable	$6,980,373
Provision for deferred taxes as a result of Sections 167 and 168 of the Internal Revenue Code	$1,293,717

[6] Contrary to petitioners' implication (Pet. 7), the issue now raised was not the principal controversy in the proceeding before the Commission. Although applications for rehearing were also filed by El Paso and by four of the other intervenors, only petitioners objected to the Commission's handling of the liberalized depreciation problem (R. 166–201). In cases Nos. 18022, 18120, and 18124 before the court below, the time for filing petitions for writs of certiorari expired December 29, 1960.

2. *Proceedings in the court below.* Four petitions for review of the Commission's orders were filed in the court of appeals by El Paso Natural Gas Company (No. 18022), Southern California Gas Company and Southern Counties Gas Company of California (No. 18120), Pacific Gas and Electric Company (No. 18124), and petitioners (No. 18125). The cases were not consolidated, but on joint motion were heard together and decided in a single opinion (Pet. App. 1–15). As was the case in the applications for rehearing before the Commission, the paramount issue before the court below was not that which is presented here, but rather the Commission's treatment of the percentage depletion and deduction of intangible drilling expenses, granted under Sections 613 and 263(c) of the Internal Revenue Code of 1954 to producers of oil and gas, but not available to taxpayers generally, as is the liberalized depreciation deduction.

The court remanded the cause to the Commission for reconsideration of the rate of return in the light of its treatment of the tax savings resulting from statutory depletion and deduction of intangible drilling expenses, which the court upheld; the court also upheld the Commission's handling of the tax benefits resulting from the use of liberalized depreciation as a tax "deferral" properly includable in El Paso's cost of service for the test year (Pet. App. 11–12).

ARGUMENT

The question of accounting practice in connection with fixing rates which was decided by the Federal Power Commission has aroused widespread public interest. It has come before many state utilities commissions and other federal agencies. It also involves large total sums of money paid in utility rates. In the present case the decision apparently raised the consumers' rates between one and two percent in the short run, with the increases being accumulated in a special reserve.

Nevertheless, we think that the case is not one for certiorari. The issue is not a basic question affecting the law of utility regulation, but a relatively narrow, though recurring, accounting problem within the discretionary province of the Power Commission. Since there is no conflict with respect to the issue involved here, and since the decision below is correct, there is no occasion for further review by this Court. Although the same issue is now pending before the Fourth Circuit in *City of Lexington, et al.* v. *Federal Power Commission,* No. 8101, argued January 4, 1961, we do not believe that the pendency of that litigation calls for a grant of certiorari in the present case.

1. Under straight line depreciation each unit of property is depreciated in equal installments over its useful life. Under the provisions of Section 167, however, a company is permitted, for tax purposes, to make larger deductions for depreciation in the earlier years, thus reducing its taxes in those years. On each property unit the larger deductions are counterbalanced by smaller ones in the later years, increasing the company's taxes during that period, so that the total

amount of deductions over the life of the property is the same under one system as under the other. This will also be the total effect of this method of handling depreciation on all plant additions, although the company may continue to pay lower taxes if it expands its plant with sufficient rapidity to counterbalance the higher taxes attributable to the later years of the older units.

In this and other cases involving companies which have elected to use liberalized depreciation, the Commission has computed taxes for cost of service purposes by the "normalization" method, *i.e.*, as though the company had used straight line depreciation rather than the varying amounts permitted for tax purposes by Section 167. The Commission has directed that the difference between the taxes actually paid during the earlier years of the life of a property and the taxes which would have been paid out but for liberalized depreciation be placed in a special reserve account against which charges are to be made, in the later years of the property's life, of the amounts by which the tax payments in the later years exceed those which would have been required had a straight line depreciation policy been used. This reserve can never be used for the payment of dividends.

2. The Commission is given broad discretion to determine just and reasonable rates. See *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591. In performing that function, the Commission has general discretion to determine what the operating costs are which should be considered in fixing reasonable rates. In addition, the Commission is expressly granted broad discretion to prescribe a system of accounts for natural gas companies under its

jurisdiction. See Natural Gas Act, Sec. 8(a), 15 U.S.C. 717g(a), *infra,* p. 22. The requirement in this and other Commission cases that the reduction in taxes caused by liberalized depreciation be credited to a special reserve account for deferred taxes was made by virtue of that discretionary authority vested in the Commission by Congress.

As suggested above, the use of liberalized depreciation by companies subject to federal or state regulation has been the subject of dispute and the source of much litigation. Regulatory agencies on both the federal and state level are divided in their views as to whether "normalization" of taxes should be required or the "flow-through" principle should be followed, by which all savings accrued as a result of the use of liberalized depreciation are immediately passed on to the rate payers.[6a] Among the federal agencies, the Federal Power Commission, the Civil Aeronautics Board,[7] and the Securities and Exchange Commission[8] subscribe to the "normalization" method, whereas the Interstate Commerce Commission[9] requires the "flow-through" method. On the state level, the regulatory commissions in twenty-two states appear to require or permit the normalization of taxes,[10] whereas regulatory commissions of eighteen states apparently subscribe to the flow-through principle.[11] From this survey, it appears that, whatever merit there may be in either method, the least that can be said is that a regulatory commission's choice between the two is assuredly within its discretion, depending on the particular views of the particular agency. No general issue of law is involved, only a discretionary choice among competing accounting systems. Such a choice is not one which warrants review by this Court. Under the same principle, the choice is one which can be changed by the Commission should it become convinced that the other method is preferable. Such a change can be made without disturbing the requirement that reserves already accumulated be used only for the originally intended consumers' benefit.

[6a] Of course, under the latter method, no reserve is accumulated to absorb any higher taxes resulting from lower deductions in later years.

[7] See Uniform System of Accounts and Reports for Certificated Air Carriers, as amended, 14 C.F.R. 241.2-6 (Supp. 1960); *General Passenger Fare Investigation,* CAB Docket No. 8008 *et al.,* decided November 25, 1960, pp. 66–69.

[8] See Securities Act of 1933, Releases Nos. 4191, 4206; Securities Exchange Act of 1934, Releases Nos. 6189, 6233; Holding Company Act, Releases Nos. 14173, 14209; Investment Company Act of 1940, Releases Nos. 2977, 3010; Accounting Series, Releases Nos. 85, 86.

[9] See All Carriers Subject to Prescribed Accounting Rules, 24 Fed. Reg. 1401.

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[10] Alabama (*In re Alabama Gas Corporation*, Non-Docket 1704, January 27, 1956); Arkansas (*In re General Telephone Company of the Southwest*, Docket No. U-1101, September 17, 1956): Florida (*Southeastern Telephone Company*, 30 PUR 3d 492, September 25, 1959); Georgia (*General Telephone Company of the Southeast*, 28 PUR 3d 452, May 20, 1959); Hawaii (*In re Honolulu Rapid Transit Company*, 28 PUR 3d 1, March 19, 1959); Idaho (*In re Idaho Power Company*, F.P.C. Docket No. R-159, memo of April 11, 1957); Illinois (*In re Union Electric Company*, 29 PUR 3d 177, July 22, 1959); Indiana (*In re Public Service Company of Indiana*, 12 PUR 3d 509, March 9, 1956, affirmed, *Boone County Rural Electric Corporation* v. *Public Service Comm.*, 159 N.E. 2d 121, Ind. Sup. Ct., June 5, 1959); Kansas (*In re Empire District Electric Company*, 23 PUR 3d 45, January 29, 1958); Kentucky (*In re Kentucky Utilities Company*, 22 PUR 3d 113, January 15, 1958); Louisiana (Louisiana Public Service Comm.; General Notice, September 25, 1955); Maryland (*In re Cumberland and Allegheny Gas Company*, Case No. 5515, Order No. 53384, April 24, 1958; see, also, letter, August 22, 1956, Maryland PSC to West Maryland Power Co.; letter, August 22, 1956, Maryland PSC to Potomac Edison Co.); Massachusetts (*Boston Edison Company*, CCH Util. Reps., para. 18438, August 14, 1959); Michigan (*In re Michigan Consolidated Gas Company*, 22 PUR 3d 369, February 6, 1958, decision adhered to on rehearing, Case No. D-3430-59.2, April 3, 1959; *In re Consumers Power Company*, D-2916-59.2, May 22, 1959); Nebraska (*United Telephone Company of the West*, Case No. A-20745, March 5, 1957); Nevada (*In re Southern Nevada Power Company*, L & S Docket 195, March 20, 1958); New Mexico (*General Telephone Company of the Southwest*, 14 PUR 3d 243, May 28, 1956; *New Mexico PSC General Order No. 18 & Supplement*, 10 PUR 3d 289); Oklahoma (*In re Oklahoma Natural Gas Company*, 26 PUR 3d 149, December 24, 1957, rehearing denied, August 1, 1958); South Carolina (*In re Lockhart Power Company*, Order No. E-772, Docket No. 10186, May 2, 1957); Virginia (*In re General Telephone Company of the Southeast*, 14 PUR 3d 239, December 19, 1955; but see P.U. Fortnightly, November 24, 1960); Wisconsin (*La Crosse Telephone Corp.*, 20 PUR 3d 94, July 23, 1957); Wyoming (*In re Black Hills Power and Light Company*, 26 PUR 3d 598, January 5, 1959).

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[11] Arizona (*In re Arizona Public Service Company*, Docket U-1345, January 26, 1959): California (General Investigations, *In re Tax Treatment of Accelerated Depreciation*, No. 6148, 33 PUR 3d 209, April 12, 1960): Colorado (*In re Public Service Co. of Colorado*, 34 PUR 3d 186, May 27, 1960): Connecticut (*Housatonic Public Service Co.*, 22 PUR 3d 1, January 22, 1958); District of Columbia (~~*In re*~~ *Potomac Electric Power Company*, 28 PUR 3d 206, April 10, 1959); Maine (*Bangor Hydro-Electric Company*, 26 PUR 3d 489, December 30, 1958); Missouri (*In re Kansas City Power and Light Company*, Case No. 13822, September 10, 1958); New Hampshire (*In re Public Service Company of New Hampshire*, 18 PUR 3d 523, April 16, 1957); New Jersey (*In re Hackensack Water Company*, Docket No. 9473, August 27, 1958); New York (*In re Central Hudson Gas and Electric Corporation*, Case No. 19449, May 26, 1959); North Carolina (*In re Public Service Company of North Carolina, Inc.*, Docket No. G-5, SUB 32, April 8, 1960) (North Carolina may be reconsidering its position); North Dakota (*In re Montana-Dakota Utilities Company*, 22 PUR 3d 505, January 24, 1958, affirmed *sub nom. Montana-Dakota Utilities Company* v. *North Dakota Public Service Commission*, 102 N.W. 2d 329, 33 PUR 3d 531): Ohio (*In re Cincinnati Gas and Electric Co.*, Ohio PUC Docket No. 27749, April 15, 1960); Pennsylvania (*Pennsylvania Public Utilities Comm.* v. *Manufacturers Light and Heat Company*, 33 Pa. P.U.C. 669, January 3, 1956, affirmed *sub nom. Pittsburgh* v. *Public Utility Comm.*, 17 PUR 3d 249, 128 A. 2d 372 (Superior Court, December 28, 1956)): Tennessee (*United Cities Gas Co.*, Tennessee PSC Docket 3936, November 21, 1957); Vermont (*In re Accounting Treatment of Accelerated Depreciation*, December 3, 1958); Washington (Formal Letter of Washington Public Service Commission to Washington Natural Gas Company, dated December

3. The Power Commission's handling of liberalized depreciation in recent years parallels the Commission's earlier treatment, with court approval, of the similar "accelerated amortization" permitted by Section 168 of the Internal Revenue Code of 1954.[12] In a rule-making proceeding in 1953, *Treatment of Federal Income Taxes as Affected by Accelerated Amortization,* 12 F.P.C. 369, the Commission found that the use of accelerated amortization would result in a tax deferral; that customers would be paying the same rates, no more and no less, with or without accelerated amortization; and that, by the use of accelerated amortization, larger amounts of money would be made available to the utility-taxpayer for investment in the construction of defense facilities. The Commission therefore concluded that, for rate-making purposes, federal income taxes should be "normalized" on the straight-line basis, but that the amounts for taxes in excess of those actually paid during the period of accelerated amortization (the first five years) should be earmarked through proper accounting procedures so as to be available to meet the increased tax liability of the taxpayer during the remainder of the life of the properties so treated.[13]

2, 1958); West Virginia (*In re Hope Natural Gas Company*, 33 PUR 3d 335, March 29, 1960).

[12] Originally, Section 124A of the Internal Revenue Code of 1939.

[13] On April 21, 1954, after notice and hearing, the Commission issued its Order No. 171, amending the Uniform System of

Following this view, the Commission held in *Panhandle Eastern Pipe Line Company*, Opinion No. 269, April 15, 1954, 3 PUR 3d 396, that for rate-making purposes Panhandle would be allowed "normalized" taxes as operating expenses.[14] On review of this decision, *sub nom. City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (C.A.D.C.), certiorari denied, 352 U.S. 829, Judge Fahy, writing for the court of appeals, upheld the Commission's treatment of accelerated amortization (*id.* at 822), although the case was remanded on other grounds.

In 1956, the normalization method of computing federal income taxes, which had previously been applied to accelerated amortization under Section 168, was held by the Commission in *Amere Gas Utilities Co.*, 15 F.P.C. 760, to be equally applicable to liberalized depreciation under Section 167. Subsequently, in 1958, the Commission made the provisions for de-

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Accounts for Natural Gas Companies, to provide for a reserve for deferred federal income taxes resulting from the use of accelerated amortization (19 Fed. Reg. 2450). The use of the account was restricted so that the temporary savings could not be used directly or indirectly for the payment of dividends. The transfer of any portion of the account to surplus was not permitted without prior approval of the Commission.

[14] In this connection the Commission said:

> The amount of any tax saving realized by Panhandle under the certificates granted pursuant to § 124A will not be the amount of the annual depreciation charge during the 5-year period, but will be the difference between what taxes it would otherwise have been required to pay without accelerated amortization and the taxes actually paid. We have computed the tax payments which would have been required without the accelerated amortization which Panhandle is permitted, and for the purposes of the rate schedules under study have considered that Panhandle will be allowed as operating expenses such normalized taxes. * * * [3 PUR 3d at 427–428.]

ferral accounting with respect to accelerated amortization equally applicable to liberalized depreciation. Order No. 203, 19 F.P.C. 826, 23 Fed. Reg. 4164.

Petitioner erroneously seeks to differentiate the *City of Detroit* case on the ground that the deduction there permitted applied only to emergency facilities and could be taken for a period of no more than five years. That those facilities were emergency in character does not alter the fact that the allowance of a more rapid tax write-off under Section 168 encourages construction of emergency facilities just as the same type of allowance under Section 167 stimulates plant construction generally. Accelerated amortization differs from liberalized depreciation only in degree: larger income tax deductions are made under accelerated amortization than under liberalized depreciation and for a shorter period at the beginning of the life of a unit of property, followed by no deductions (instead of merely smaller deductions) for the rest of the property life. Thus, over the full life of the property total deductions are the same in both cases.

4. Although petitioners' contention (Pet. 16–18), that the amount in the reserve fund represents, not a tax deferral, but a tax saving to be passed on to consumers, is a contention which has been upheld by other regulatory commissions (see *supra*, pp. 9-12), the Power Commission, in the exercise of its discretion, believes that its position is more valid in the context of the type of regulation it carries on. Petitioners' assumptions of a continual plant growth and a continuously expanding investment in depreciable property, *i.e.*, plant additions exceeding retirements,

are at best largely speculative and conjectural. It was within the Commission's discretion to decline to make these assumptions. On the other hand, it is known, and petitioners must concede, that, as the tax law now stands, higher deductions and lower taxes prevail only during the early depreciable life of a property unit, whereas lower deductions will prevail during its later life. Petitioners therefore do not, and cannot, show that the ultimate net result will be an outright tax saving. In a subsequent case involving the same question, *United Fuel Gas Company*, 23 F.P.C. 127, 131, now pending before the Fourth Circuit *sub nom. City of Lexington, et al.* v. *Federal Power Commission, supra*, the Commission said:

> We think that it would be speculative to assume that company expansion and price inflation will continue indefinitely and to assume that the net effect of liberalized depreciation will be to lower taxes each year in the foreseeable future.

Moreover, it is to be borne in mind that the wise choice of rules may depend upon the characteristics of the particular industry. The state commission cases have seldom, if ever, involved the natural gas pipeline industry. Continued expansion for the indefinite future can more readily be assumed for the electric power and telephone industries than for gas pipelines, which are dependent on the continuing discovery of exhaustible gas reserves. In the case of El Paso itself, the sufficiency of its gas reserves has been a matter of concern. In *El Paso Natural Gas Co.*, 22 F.P.C. 900, a certificate proceeding, El Paso claimed a fifteen-year supply. The Commission staff estimated only six years, and the examiner determined eight years. Subsequently, based on an additional showing by El Paso, it was stipulated that its gas reserves were enough to support the sale then at issue. The Commission accepted the stipulation but added that any future authorizations to El Paso would have to be based on additional reserves "in excess of the annual increments necessary to maintain the existing minimum balance for its present services" (22 F.P.C. at 904). In the light of El Paso's gas reserves, the Commission's refusal here to assume continuing future expansion was a reasonable exercise of its discretion.

In any event, the result of an increasing plant account would not affect the legal validity of the Commission's decision. The tax benefit resulting from the liberalized depreciation granted in connection with a particular unit of property ends with the life of that unit. The fact that other benefits will be beginning with respect to other units does not change the effect of the way in which the earlier unit was depreciated. The portion of the reserve set up in connection with that unit will have grown, declined, and disappeared, and will have performed its function of causing the corresponding depreciation charges to be properly reflected, year by year, in the amount of taxes included in cost of service for ratemaking purposes.

5. By like token, petitioners do not present a valid argument when they maintain (Pet. 21–22) that the Commission's treatment of liberalized depreciation illegally places on consumers the burden of contributing to the capital of the utility. In the Commission's

view, inclusion of the deferred taxes in computing the cost of service, as well as placing them in the reserve account with restricted use, will not result in higher rates to the consumers over the life of the units of property involved; nor does it operate by itself to reduce them. Cf. *City of Detroit* v. *Federal Power Commission, supra,* 230 F. 2d at 822. Since the consumer has no legal claim to the tax benefits accorded by Section 167, the denial of the benefit, in the form of reduced rates, cannot be considered a capital contribution as a matter of law.

Moreover, it should be stressed that, in the present case, the Commission did not purport to answer the question of how the normalization of taxes should affect the fixing of an appropriate rate of return. The question was specifically reserved to other proceedings where "the reserves accumulated * * * would have an actual and favorable effect on the company's cost of money * * *" (R. 116; see n. 4, *supra,* p. 5). In a recent opinion handed down by the Commission on March 7, 1961, this question was raised for the first time, and the Commission allowed a return of 1.5% on the accumulated deferred taxes, which in effect allowed benefits both for the pipeline and consumers. *Northern Natural Gas Co.,* Opinion No. 342, Docket Nos. G-19040, G-19041, pp. 3-13 (involving Section 167); accord, *Kansas-Nebraska Natural Gas Co.,* Opinion No. 343, Docket No. G-12391, decided March 8, 1961, pp. 3-5 (involving Section 168). In the *Northern Natural* opinion (pp. 11-13), the Commission pointed out that the normalization of taxes could actually result in lower rates to the consumers because the accumulation of reserves by the companies permits plant expansion which would otherwise have to be financed in the open market. By open-market financing, the companies would have to have rate levels sufficient to cover the cost of this financing and the taxes associated with it, which in turn would have to be correspondingly higher.

6. Petitioners' other legal objections to the Commission's treatment of liberalized depreciation allowances are based upon an uncritical reiteration of generalized principles of rate determination and upon equally uncritical citations of decisions which do not reach, or are not addressed to, the problem before the Court. For instance, in *Galveston Electric Company* v. *Galveston,* 258 U.S. 388, cited by petitioners (Pet. 14), this Court merely held that all taxes which would be payable if a fair rate were earned are properly included in the cost of service. The Court was not dealing with the present problem, nor is there anything in its opinion holding that the regulatory body calculating cost of service is necessarily governed by the amounts of taxes, or any other expense, actually paid during the test year. On the contrary, the Court said with respect to the amount of maintenance expense included in cost of service (258 U.S. at 398).

> The proper annual charge for maintenance is the amount normally required for that purpose during the period; it is not necessarily the amount expended during the year.[15]

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[15] The Commission's statement with respect to allowance for taxes paid in *South Carolina Generating Company,* 16 F.P.C. 52, 65, also cited by petitioners (Pet. 15), is likewise inappli-

None of the cases cited by petitioners would preclude the Commission from recognizing, in its discretion, that the shifting in the timing of depreciation shifts the timing of taxes, and thus creates a tax deferral.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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April 1961.

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cable; the Commission was there considering an entirely different situation. And, in any event, on appeal the appellate court required, because of the particular corporate structure and financing, that more than the actual taxes paid by the company be included in its cost of service. *South Carolina Generating Co.* v. *Federal Power Commission*, 249 F. 2d 755, 763 (C.A. 4), certiorari denied, 356 U.S. 912: see also *South Carolina Generating Co.* v. *Federal Power Commission*, 261 F. 2d 915, 920 (C.A. 4).

APPENDIX

Pertinent sections of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717, are as follows:

SECTION 4 (15 U.S.C. 717c):

> (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.
>
> * * * * *
>
> (e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided,* That the Commission shall not have authority to suspend the rate, charge,

classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classifiication, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

SECTION 5 (15 U.S.C. 717d):

(a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, **or are not the lowest reasonable rates.**

* * * * *

SECTION 8 (15 U.S.C. 717g):

(a) Every natural-gas company shall make, keep, and preserve for such periods, such accounts, records of cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may by rules and regulations prescribe as necessary or appropriate for purposes of the administration of this chapter: * * *. The Commission may prescribe a system of accounts to be kept by such natural-gas companies, and may classify such natural-gas companies and prescribe a system of accounts for each class. The Commission, after notice and opportunity for hearing, may determine by order the accounts in which particular outlays or receipts shall be entered, charged, or credited. * * *

* * * * *

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In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 599

PEOPLE OF THE STATE OF CALIFORNIA AND
PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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In the Supreme Court of the United States

October Term, 1960

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People of the State of California and
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Petitioners,

vs.

Federal Power Commission,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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In accordance with Rule 24(4) of the Revised Rules of the Supreme Court of the United States, the petitioners, the People of the State of California and the Public Utilities Commission of the State of California (California), submit this brief in reply to the brief for respondent Federal Power Commission (Commission) in opposition to

California's Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit.[1]

ARGUMENT

Although admitting that the question here presented "has aroused wide spread public interest" and that it "also involves large total sums of money paid in utility rates", the respondent Commission takes the surprising position that the "issue is not a basic question affecting the law of utility regulation, but a relatively narrow, though recurring, accounting problem within the discretionary province of the Power Commission."[2] California asserts that the issue raised here is of great public importance, that it presents a basic question which goes to the heart of rate regulation, and that it affects the rates which the gas consumers of the nation must pay. This is hardly a mere "accounting problem."

1. The Issue Before This Court Is One of Great Public Importance.

Judged in terms of economic impact, the Commission's treatment of liberalized depreciation in connection with the calculation of Federal income tax expense for cost of serv ice purposes has resulted in the retention by utilities of millions of dollars paid by gas consumers for an expense which simply does not exist. For El Paso alone, the accumulation of such funds totals almost $22,000,000 for the period 1954 through 1959; and, for the same period, the accumulation of funds by all regulated natural gas companies in a reserve for hypothetical taxes has reached a total in excess of $152,000,000.[3] It is said that, in the case of regulated electric utilities, the amount accumulated is around one billion dollars.[4]

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[1] It is to be noted that El Paso Natural Gas Company (El Paso) has moved this Court that it be made a party respondent on the ground that it is the natural-gas company whose rates are at issue in this proceeding. El Paso's motion apparently is pending at the present time. California has not opposed the motion and El Paso apparently in the expectation that its motion will be granted has served on the parties to this proceeding its brief in opposition. It is our understanding that El Paso's brief has not been accepted for filing pending the disposition by this Court of El Paso's motion. For this reason, California's reply brief is addressed to the brief in opposition filed by respondent Federal Power Commission. However, where appropriate, cognizance will be taken here of arguments advanced by El Paso in its brief in opposition on the assumption that the Court in all probability will grant El Paso's motion and thus permit El Paso's brief in opposition to be filed.

[2] Comm. Br., p. 7.

The Commission attempts to argue these huge amounts away with the observation that its "decision apparently raised the consumers' rates between one and two percent in the short run, with the increases being accumulated in a special reserve." This type of argument is of course familiar. It is often employed by those who would seek to gain large sums of money for their own benefit by spreading the impact of a price increase among a large group of consumers. But, when such a specious argument is employed by an agency of the United States charged with the duty of administering the Natural Gas Act, which was enacted for the benefit and protection of the nation's gas consumers,[5] California is required to express its deep concern for the future of regulation under that Act. At any rate, the figures speak for themselves. The economic impact on gas consumers is clear. And this Court, we are confident, will not be persuaded by so specious an argument to conclude that the question presented here does not deserve its review on the ground that insufficient money is involved. This case presents another instance of a state being compelled to litigate on behalf of its consumers against the Federal agency which has the primary duty to protect such interests. This case presents another instance wherein a state is seeking the assistance and protection of the Supreme Court on behalf of its gas ratepayers.

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[3] Pet., p. 13.

[4] Br. Amici Curiae of Pennsylvania, et al., p. 5.

[5] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. ~~591 (1944)~~; *Atlantic Refining Company v. Public Service Commission of New York*, 360 U.S. 378 (1959).

2. The Question Presented Raises an Issue Involving Basic Regulatory Law.

It requires no citation of authority or precedent to point out that utility rate regulation proceeds upon the basis of setting rates so as to cover expenses and so as to provide a return on the property used or useful in the performance of the service in question. Federal income taxes are an expense to be treated no differently from any other expense of doing business. The actual expense, and no more, provides the index for proper rate making. In departing from these fundamental rate making principles by requiring ratepayers, in effect, to prepay an expense which may never occur, the Commission itself has embarked upon a course of rate fixing and regulation by guess and by hazard. Such a method of rate fixing cannot proceed from a proper, or any, concern as to the welfare of gas consumers. It is not a method of rate fixing which is consistent with the setting of those rates which are "just and reasonable" and no more.

The Federal Power Commission from the inception of its responsibility for the regulation of the natural gas industry has fixed rates in relation to costs plus a reasonable rate of return. Operating expenses claimed, but not founded upon provable costs, have consistently and promptly been rejected as false items in the rate making process. The Commission in its heretofore consistent interpretation of costs as the foundation of reasonable rates under the Natural Gas Act has predicated such rates only upon showings based upon actual costs.

The great departure from this practice and the protection of the public interest which it affords came in the present controversy. The Commission's decision to charge ratepayers for a non-existent expense represents a sharp break with all previous agency decisions and all previous agency interpretations involving the Commission's duties under the Natural Gas Act. The past has been rejected and a new, unknown rate making formula has been adopted, based upon an allowance for tax expenses admittedly not incurred in the test year and, because of the ever growing nature of the utility industry, an allowance for an expense which will never materialize.

Because of the Commission's departure from the accepted principles of rate making, the question presented is one of basic regulatory law, and the issue deserves review by this Court.

3. The Question Presented Is Not a Mere "Accounting Problem".

The Commission takes the position that we are here confronted with only an accounting problem.[6] In this connection the Commission refers to its authority to prescribe accounting procedures, which it says is a matter for its discretion.[7]

Although it is fair enough to say that accounting is involved, as it certainly is in any rate making proceeding, it is not fair to characterize the imposition on ratepayers of huge prepayments for a speculative expense as a matter involving bookkeeping alone. This case deals with rate making under the Natural Gas Act. The short answer to the newly-posed "accounting" theory of the Commission lies in quoting its opinion in this case:

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[6] Comm. Br., p. 7.

[7] Comm. Br., p. 8.

> "In the Matter of
> El Paso Natural Gas Company
>
> OPINION NO. 326
>
> OPINION AND ORDER DETERMINING RATES AND PROVIDING FOR REFUND
>
> This proceeding arose from the filing on October 14, 1954, by El Paso Natural Gas Company pursuant to Section 4 of the Natural Gas Act of new rate schedules to its FPC Gas Tariff, Original Volume No. 1 providing for an increase in rates that was estimated to amount to $18,113,000 annually on the basis of the year 1954." (R. 162)

The purpose and result of the proceeding, as California feels the Commission is aware, was the fixing of rates, not the promulgation of accounting rules.[8] Should one accept the Commission's argument in this regard, the imposition on ratepayers of prepayments for speculative increases in tax rates, administrative and general expenses, operating costs, and so on, can as easily be justified under the guise that only accounting is involved, because credits for such speculative expenses will be lodged in a reserve account to guard against the day when such conjectural expenses may materialize, if ever.

California maintains that the question here presented is whether ratepayers may be legally required to pay rates designed to cover the supposed payment of a non-existent expense. The answer to this question is in the negative, and thus no so-called accounting problem arises at all if this question be answered correctly in the first instance. In this very proceeding rates and charges were increased in part because of charges for taxes not in fact presently incurred by the pipeline utility. This was part of applicant's showing; it constituted one of the bases upon which increased rates and charges were authorized and collected.

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[8] An accounting order dealing with liberalized depreciation was promulgated earlier by the Commission in *Amere Gas Utilities Co., et al.*, 15 FPC 760, 781 (1956). The case now before this Court constitutes the first instance where the philosophy of the *Amere* decision was applied in the context of rate making.

4. The Question Presented Is One of Law, Not One of Administrative Discretion.

With less than complete candor the Commission argues that its treatment of liberalized depreciation for rate-making purposes was a determination involving the exercise by it of its discretion.[9] In reply, California must state that this is the first time the Commission has seen fit to make such a claim. Until this moment, it was clear that the Commission's determination was dictated by its conception of the Congressional intent thought to be the motivation of Congress in enacting Section 167 of the Internal Revenue Code of 1954. In its opinion in this very case, the Commission referred to its interpretation of the legislative history of Section 167, such interpretation (erroneous, in our view) being to the effect that Congress intended that regulated utilities should retain tax savings generated by the deduction for liberalized depreciation (R. 171).

The Commission stated:

> "The reasoning of the Committees of Congress is, we believe, conclusive upon us." (R. 171)

Referring to its accounting order in the *Amere* case,[10] the Commission went on to say:

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[9] Comm. Br., pp. 7, 8, 11, 14.

[10] *Amere Gas Utilities Co., et al.*, 15 FPC 760, 781 (1956).

"We concluded in the *Amere* case that we could not strike down an Act of Congress and we must apply Section 167 to the natural gas companies. As stated in our order we would call the situation to the attention of Congress by transmitting copies of the presiding examiner's decision and our order to the Chairman of the Finance Committee of the Senate and the Chairman of the Ways and Means Committee of the House, and we did so by our letter dated July 2, 1956. Since that time Congress has not amended the Internal Revenue Code or the Natural Gas Act in this respect, thus affirming our interpretation of its intentions. Compare *United States v. American Trucking Associations*, 310 U.S. 534, 549; *Signal Oil and Gas Co. v. F.P.C.*, 238 F.2d 77, (CA 3), *certiorari denied*, 353 U.S. 923. In this connection we may note that a bill, S. 2113, 85th Congress, first session, provided, among other things, that in the determination of the rates of public utilities subject to the Federal Power Act, the Commission must not include tax savings arising as a result of Sections 167 and 168 of the Internal Revenue Code but this bill was never enacted into law.

"In order to carry out the intention of Congress as contemplated in the *Amere* case, we issued our Order No. 203, amending the Uniform System of Accounts, 19 F.P.C. 826. In that order we set up a new Account 266, Accumulated Deferred Taxes on Income, which would be credited, and a revised Account 507-A, Provision for Deferred Taxes on Income, which would be debited, with amounts by which income taxes for the year are lower because of the use of liberalized depreciation. * * *" (R. 172-173)

The following excerpts from the *Amere* decision also demonstrate that the Commission's determination was based solely on its view of Congressional intent:

"Admittedly, section 167 of the Internal Revenue Code contains no specific mandate to create a reserve account for deferred taxes. Nevertheless, we know of no way to effectuate the clear and obvious congressional intent, except by doing so. * * *

* * * * * * *

"It is clear that the charging of greater depreciation during the early life of property and the charging of less during the later life operates to create a deferral of income taxes. The fact that there may be continuing additions to plant, year by year, with the result that there will be a balance in the reserve account at all times in the foreseeable future, does not prove that there is no tax deferral. On the contrary, it proves that there is a continuing tax deferral so long as additional facilities are being installed. This is precisely what Congress intended.

* * * * * * *

"We cannot strike down an act of Congress if we think it unwise, or unnecessary to a particular industry, and enforce it only if it is in accord with our economic and regulatory philosophy. It is undisputed that section 167 of the Internal Revenue Code does apply, and was intended to apply to regulated natural gas companies, such as the petitioners.

* * * * * * *

"We are calling this situation to the attention of the Congress by transmitting copies of the presiding examiner's decision, our opinion herein, and the dissenting opinion attached hereto, to the chairman of the Finance Committee of the Senate and the chairman of the Ways and Means Committee of the House." (15 FPC 760, 782)

The Commission is compelled to indulge in imaginative writing to adopt now, and for the first time, the position that its judgment in this case proceeded from an exercise of its discretion.

In an even more recent case than the one presently at bar, where the rates of a regulated pipeline were being fixed, the Commission stated unequivocally:

> "We are not using our discretion, but following the intention of Congress in determining that the utility is privileged to retain initially the benefits of all three tax incentives—liberalized depreciation, percentage depletion, and the intangibles." (*United Fuel Gas Company*, 23 FPC 512, 513 (1960))

We think the Commission owes it to this Court honestly to inform it of the basis for its decision. As we have demonstrated, the Commission has certainly failed to do so when it represents to this Court that its treatment of liberalized depreciation was founded upon an exercise of its administrative discretion.

In this connection, too, the opinion of the court below makes no mention of discretion as the predicate for the Commission's decision. Rather, its approval of that decision rests upon its erroneous construction of the problem as involving a "deferral" for which no rate "adjustment" could be made in the future. These errors were discussed by California in its petition for a writ of certiorari.[11]

There is no question that the Commission has broad discretion in many matters. But, its discretion is not without limits. Administrative discretion, claimed to have been exercised in connection with the promulgation of an accounting rule, cannot be employed to bolster a decision which imposes a huge economic burden on consumers without legal justification. The Commission possesses no special expertise in construing a federal tax statute. Because of the inconsistency in the position of the Commission on this issue neither California nor any other state or interest affected by the rulings of this agency is able to know when the Commission says what it means or, importantly, when the Commission means what it says. California urges review in this case so that the Commission itself can be apprised of the proper limits of its discretion in rate making proceedings under the Natural Gas Act. Its interpretation of the intent of Congress in enacting Section 167 as it may apply in the context of rate regulation under the Natural Gas Act was erroneous, and the Commission may be said to have tacitly admitted this by its newly announced attempt to justify its determination as an exercise of administrative discretion. Its "latest edition" version of the rate making treatment of tax savings is rather clear evidence of the Commission's inconsistency, uncertainty, and, indeed, whim upon so important a controversy.

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[11] Pet., pp. 16-21.

The same observation may be made with respect to the Commission's attempt to fortify its claim that the question here presented raises only an issue involving discretion by its reference to "the characteristics of the particular industry", more specifically the fact that El Paso sells gas which is an exhaustible resource.[12] No mention of this "reason" has heretofore been made by the Commission in its opinion in this case, nor was such a "reason" urged by the Commission before the court below. As we have seen from the Commission's opinion in the *Amere* case, *supra*, its opinion in the instant case, and its more recent opinion in the *United Fuel Gas Company* case,[13] the Commission's treatment of liberalized depreciation was compelled by its interpretation of the Congressional intent thought to be the motivation for Section 167.

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[12] Comm. Br., pp. 15-16.

[13] The *United Fuel Gas Company* case, 23 FPC 512 (1960) is presently before the Court of Appeals for the Fourth Circuit, *sub nom. City of Lexington, et al. v. Federal Power Commission*, argued Jan. 4, 1961. The identical question presented here is also before the Fourth Circuit in that case.

Typical of the Commission response in this case is the newly-contrived and convenient reasoning coming from so-called discretion. Now the Commission poses the premise that El Paso's expansion and growth are somehow restricted. Never at any time in the record in this case, either before the agency or before the court below, did the Commission ever seek to justify its treatment of the tax savings under Section 167 by arguments based upon El Paso's gas reserve supply. In fact, as we have pointed ~~out here~~inabove, the Commission relied entirely on its interpretation of Congressional intent.

There is no showing in this record, or elsewhere, as to any bleak economic future for El Paso! On the contrary, El Paso has shown a consistent growth since the inception of its business as a natural gas company in 1929. In that year El Paso's pipeline was 200 miles in length, with a delivery capacity of 36,000,000 cubic feet. Presently its system is 6,700 miles of main and lateral pipelines, with a certificated delivery capacity of approximately 2.7 billion cubic feet of gas per day. With the rapidly increasing population of the State of California and the consequent growth of the California market for natural gas, it seems unrealistic, to put it mildly, that El Paso will in the foreseeable future suffer an absolute reduction in its plant. And, it seems fair to point out once again that the payment of so called "deferred" taxes in connection with the use of liberalized depreciation is not dependent upon an assumption of "continuing future expansion" in plant, as the Commission seems to imply.[14] Rather, no taxes relating to the use of liberalized depreciation can possibly become due unless there is an absolute reduction in the plant used or useful in providing the service. Certainly there is no likelihood of this event in the foreseeable future, where the plant in question is largely pipelines having a life in excess of 50 years. Thus, the Commission's resort to its discretion as the cornerstone for its determination to charge ratepayers in advance for a speculative tax liability appears to be no more than a last ditch attempt to justify an otherwise unjustifiable decision.

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[14] Comm. Br., p. 16.

5. The Commission Errs in Asserting That the Question Presented Is of Less Importance Than Others Posed for the Consideration of the Court Below.

At page 6 of its brief in opposition, the Commission states:

> "* * * the paramount issue before the court below was not that which is presented here, but rather the Commission's treatment of the percentage depletion and deduction of intangible drilling expenses, granted under Sections 613 and 263(c) of the Internal Revenue Code of 1954 to producers of oil and gas, but not available to taxpayers generally, as is the liberalized depreciation deduction."

California states that this simply is not the fact. All three issues were important and each was carefully briefed and vigorously argued by California in the court below. As the Court of Appeals itself stated:

> "All parties present their cases here on the theory that we have an uncomplicated legal question as to how to treat the tax savings benefits which Congress clearly sought to afford either this particular industry or to businesses generally (as to the rapid depreciation option) in the making of just and reasonable rates

> for the sale of natural gas in interstate commerce." (Pet. App., p. 4; footnote omitted).

The court further stated:

> "We thus come to the question: What effect must the Commission give to the tax incentives provided by Congress for the gas industry, as relates to the percentage depletion and intangible drilling expense items and to taxpayers generally, as relates to the rapid depreciation item in arriving at a just and reasonable rate?" (Pet. App., p. 6)

It is therefore seen that no one particular issue was singled out by California or any other party to this proceeding as being more important than any other issue. All the issues posed for the consideration of the court below were issues of major public importance, and the Commission's attempt to minimize the importance of the issue relating to liberalized depreciation by its claim that the issue was of little importance in the court below should be seen for what it is: A misstatement of fact.

California cannot accept the Commission's version of the proceedings in the court below. At page 6 of the Commission's brief it recited that this cause was remanded to the Commission for further treatment "in the light of its treatment of the tax savings resulting from statutory depletion and deduction of intangible drilling expenses, *which the court upheld*:"[15] The court did not uphold the Commission. On the contrary—and again California feels that the Commission is aware of this—the court reversed the Commission on these two tax items. California addresses this error to the attention of this Court and deems it meaningful as demonstrative of the confusion which a pears to exist upon the part of the Commission as to the nature of this case, the basis of its own decision, the reasons for it in the first instance, and its disposition by the court below.

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[15] Emphasis supplied.

6. In Its Brief in Opposition, the Commission Seems to Admit, Though Tacitly, That Its Treatment of Liberalized Depreciation Involves a Contribution by Ratepayers to the Capital of the Utility.

At page 17 of its brief, the Commission points out that in decisions[16] subsequent to the one here in issue it has permitted the utility to earn a rate of return of 1½ percent on the accumulated funds in the special reserve for "deferred" taxes. The Commission does not deny that these sums in the reserve are generated by the payment of rates, because it cannot deny that fact. The Commission does not assert that such sums were contributed to the utility by its investors, for it cannot make such an assertion. The Commission simply cannot argue against the fact that the money represented by the reserve is money extracted from ratepayers any more than it can argue against the fact that such money constitutes capital for the utility. That the Commission permits the utility to charge ratepayers in rates an amount equal to 1½ percent of the ratepayers' own contribution of funds to the capitalization of the utility is a strange answer indeed to California's argument that the Commission's treatment of liberalized depreciation, approved by the court below, results in an unlawful, compulsory contribution by ratepayers to the capital of the utility.

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[16] *Northern Natural Gas Co.*, Opinion No. 342, FPC ; mimeo, pp. 3-12; *Kansas-Nebraska Natural Gas Co.*, Opinion No. 343, FPC ; mimeo, pp. 3-5. Both these cases were decided by the Commission in March, 1961.

7. El Paso's Assertion That the Issue Relating to Liberalized Depreciation Is Not Ripe for Review Is Incorrect.

In El Paso's response to California's petition for a writ of certiorari, El Paso takes the position that, inasmuch as the court below remanded the case to the Commission for further administrative proceedings relative to fixing a proper rate of return, the judgment of the Court of Appeals regarding the treatment to be accorded liberalized depreciation is not a final judgment capable of review by this court.[17]

As for this argument, California wishes only to point out that the remand by the court below has nothing to do with the legal question brought before this Court by California's petition, and, therefore, it cannot be assumed that the Commission on remand will reverse itself and disregard the opinion of the Court of Appeals with respect to the question relating to the treatment to be accorded liberalized depreciation in the rate-making process under the Natural Gas Act. As to this question the judgment of the court below is final, and California is required to bring it to this Court for its review at this time or be held to have acquiesced in the judgment of the court below.

CONCLUSION

California views this cause as containing an important legal issue having significant and important economic impact. The rather cavalier treatment accorded it by the Commission is not in keeping with the significance of this controversy. As this brief demonstrates, however, the Commission is now, and has been, inconsistent with itself. Throughout the history of this case, before the Commission and before the court below, the Commission has always taken the position that its treatment of the deductions resulting from Section 167 of the Internal Revenue Code was controlled by Congressional intent. Now, for the first time in these many years of litigation, we are apprised by the Commission, through its brief, that this was not a question of Congressional intent, and therefore a legal issue to be determined by this Court, but was rather a question for the discretion of the Commission.

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[17] El Paso Br., p. 7.

For the reasons stated herein as well as for the reasons contained in California's petition for a writ of certiorari, California respectfully submits that the question here presented fully deserves review by this Court, and California prays that its petition for a writ of certiorari be granted.

Respectfully submitted,

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Attorneys for the People of the State of California and the Public Utilities Commission of the State of California.

April 25, 1961.

In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 599

[illegible] OF THE STATE OF CALIFORNIA and PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, PETITIONERS,

vs.

FEDERAL POWER COMMISSION and EL PASO NATURAL GAS COMPANY

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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Brief for El Paso Natural Gas Company in Opposition

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In the Supreme Court of the United States

October Term, 1960

No. 599

People of the State of California and Public Utilities Commission of the State of California, petitioners,

vs.

Federal Power Commission and El Paso Natural Gas Company

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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Brief for El Paso Natural Gas Company in Opposition

OPINIONS BELOW

The decision of the Presiding Examiner, R. 143, is unreported. The Federal Power Commission's Opinion No. 326, R. 162, is reported at 22 F.P.C. 260, 29 P.U.R. 3d 469, and CCH Util. Law Rep. (2d ed.) ¶9918. The Commission's Opinion No. 326-A, R. 259, rendered on denial of rehearing, is reported at 22 F.P.C. 659, 30 P.U.R. 3d 308, and CCH Util. Law Rep. (2d ed.) ¶9930. The opinion of the Court of Appeals, R. 278, Pet. App.

1, is reported at 281 F.2d 567, 35 P.U.R. 3d (Adv.) 257 and CCH Util. Law Rep. (2d ed.) §10,068.

JURISDICTION

There were four cases before the Court of Appeals, viz. Nos. 18022, 18120, 18124 and 18125, arising on four petitions to review a single order, R. 162, 207-09, of the Federal Power Commission. See Pet. 1, n. 1. Petitioners here ("California PUC") were petitioners in No. 18125 below. The four cases were not consolidated, but following a joint motion, R. 6, were heard together and decided in a single opinion. R. 278, Pet. App. 1.

Identical judgments of the Court of Appeals in all four cases were entered August 2, 1960. R. 293, Pet. App. 14. On August 22, 1960, within the 21-day period allowed by the Court of Appeals' Rule 29, California PUC filed a petition for rehearing in No. 18125 only, R. 295; this petition was denied September 30, 1960. R. 317. No petition for rehearing or for certiorari was filed with respect to the judgments in Nos. 18022, 18120 or 18124, and the time for filing either sort of petition has expired. The present petition, which seeks review only of the judgment in No. 18125, Pet. 1 and footnote 1, pp. 1-2, was filed December 23, 1960. This Court is, therefore, without jurisdiction to alter the judgments in Nos. 18022, 18120 or 18124, which are the same as the judgment sought to be reviewed.

QUESTION PRESENTED

In determining, pursuant to §§ 4(e) and 5(a) of the Natural Gas Act, 15 U.S.C. 717c(e), 717d(a), the just and reasonable rate to be charged by a natural-gas company for the sale of natural gas, is it unlawful for the Federal Power Commission to allow the seller an opportunity to retain the tax benefits of "liberalized depreciation" conferred by Congress on all taxpayers by § 167 of the Internal Revenue Code?

STATEMENT

As in other Natural Gas Act rate cases,[1] the Commission began by determining a "cost of service" for the regulated company (El Paso), that is, by ascertaining El Paso's revenue requirement for the "test year." R. 164-188. This revenue requirement comprises many items, such as operating expenses, depreciation, depletion, return, and taxes, including federal income taxes. R. 188. Having made the computation of required revenues, the next "problem is to allocate to each class of the business its fair share of the costs," R. 189, and this was done. R. 188-201. Finally, there is the problem of translating the costs so allocated into rates, or "rate design." R. 201-214. The net result of the ascertainment of the revenue requirement, the classification and allocation of the required amounts and the "design" into rates, is a rate schedule setting out a fixed amount to be paid by each customer or class for each unit of gas service, for the period involved in the case. R. 205.

The Commission in addressing itself to this task necessarily met and decided a host of legal questions. R. 162-209. Its decision on a number of them was challenged by petitions for rehearing, R. 222-259, and the questions so raised were dealt with in the opinion on denial of rehearing. R. 259-276. Several of the questions thus preserved for review were presented to the Court of Appeals.

One of these, and one only, is now made the subject of a petition for certiorari. This question is far less important than other issues in the case; it is ripped from its context, in which it was but one element of one of many items dealt with at the threshold of the ratemaking process. It was among the several questions decided by the Commission relating to the amount of the allowance to be made for federal income taxes in El Paso's revenue requirement for the test year.

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[1] This case arose out of the filing by El Paso on December 14, 1954, pursuant to § 4 of the Gas Act, of amended gas rate schedules which went into effect on April 15, 1955. June 28, 1957 El Paso filed new rate schedules, which were suspended by the Commission, became effective January 1, 1958, and are now undergoing Commission review at Docket No. G-12948. See R. 163. The rates in this proceeding are therefore "locked in," which is to say, that this case does not involve future rates but only the question what, if any, refunds El Paso shall be required to make on account of rates collected during the locked-in period, April 15, 1955 through December 31, 1957.

Congress has used the Internal Revenue Code not merely as a means of taxation, but also as an instrument of national defense policy and of economic policy. By § 124A of the 1939 Code, now § 168 of the 1954 Code, Congress sought to encourage the construction of defense facilities by promising a "fast tax write-off," that is, by permitting their cost to be deducted in full in five years, instead of requiring the deduction to be spread over the useful life of the property.[2] By § 167 of the 1954 Code, Congress sought to foster broad economic growth by permitting "liberalized depreciation" of all kinds of new plant and equipment.[3]

These statutes make no distinction between the regulated and the unregulated taxpayer, nor is there any basis in legislative history for making one. In every Federal Power Commission case, including this one, and in the only previous case which reached the Court of Appeals, it was held that Congress intended no such distinction: the regulated taxpayer is entitled to retain the tax benefit, just as the unregulated taxpayer does. If it were stripped of the benefits by regulation, the company would have no incentive to do what Congress sought to encourage; with respect to the regulated segment of the economy, Congressional policy would be frustrated.

Treatment of Federal Income Taxes, 12 F.P.C. 369, involved the tax benefits of accelerated amortization in relation to natural-gas companies and electric utilities. The Commission held that Congress

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[2] This deduction is often referred to as "accelerated amortization."

[3] That is, by permitting the use of such methods of depreciation as "declining balance" and "sum of the years-digits," which result in greater deductions in the earlier years of an asset's life than the "straight-line" method.

> "obviously did not intend to make cash donations to the particular persons who happen to be, during the 5-year period of accelerated amortization, the customers of the particular utilities which have received certificates of necessity";

instead, the benefits of accelerated amortization were intended for the companies, to induce them to construct defense facilities. 12 F.P.C. at 371.

A gas rate case, *Panhandle Eastern Pipe Line Co.*, 3 P.U.R. 3d 396, presented the same question, and resulted in the same decision. On review, the Court of Appeals, District of Columbia Circuit, unequivocally agreed with the Commission that the Internal Revenue Code's provision on accelerated amortization "is not to benefit consumers but rather the taxpayer in order to encourage construction of certain emergency types of facilities." *City of Detroit v. FPC*, 230 F.2d 810, 822.[1] The Court added,

> "This statute, unlike the Natural Gas Act itself, is not for consumer benefit. It has a different public policy and should be given effect as intended by Congress. Furthermore, the solution of the Commission does not result in higher rates to the consumer. It simply does not operate to reduce them. It aids Panhandle but neither aids nor harms petitioners. We think this is the result sought by Congress."

The same result was reached for the same reasons in the case of liberalized depreciation. *Amere Gas Utilities Co.*, 15 F.P.C. 760. The Presiding Examiner found underlying Int. Rev. Code § 167 a Congressional purpose to stimulate modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living. Accordingly, he followed the *Panhandle-City of Detroit* decision, and held that the tax benefits of liberalized depreciation, like those of accelerated amortization, belong to the regulated company, not its customers, 15 F.P.C. at 775, 779-81. The Commission agreed, holding that it could "find no legal difference" between the ratemaking aspects of accelerated amortization and liberalized depreciation 15 F.P.C. at 781-82.

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[1] Petitions for certiorari were filed in that case, but did not raise this issue. (Nos. 98, 113, O.T. 1956, denied at 352 U.S. 829.)

This case involves the tax benefits of "liberalized depreciation", allowed by § 167 of the 1954 Internal Revenue Code. El Paso exercises the option to deduct liberalized depreciation on the declining balance method, as permitted by Int. Rev. Code § 167(b)(2). R. 151. The Presiding Examiner held that the problem was squarely covered by the precedents, R. 155-57; the Commission agreed. It held that the question as to liberalized depreciation tax benefits had been "already, in effect, decided" in the *Amere* case. R. 171-72.

Timely petitions for rehearing were filed by El Paso[5] and by each of the respondents. R. 222, 224, 225, 254. Following their denial, R. 259, four petitions for review were filed in the Court of Appeals, Fifth Circuit.[6]

The Court decided three main points, one of which is made the sole subject of the present petition for certiorari. In a single paragraph of a 15-page opinion, the Commission's treatment of liberalized depreciation was approved. R. 290-91.

The judgment[7] was that the proceedings be remanded to the Commission, R. 292, 293-94, with directions to hold further administrative hearings.

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[5] El Paso's petition for rehearing related to issues not involved on this petition. R. 254-59.

[6] The petitions for review were filed within sixty days after the order of the Commission upon the applications for rehearing, and the Court of Appeals had jurisdiction over the proceedings under § 19(b) of the Gas Act, 15 U.S.C. 717r(b).

[7] As noted above, the identical judgment was entered in all four cases.

ARGUMENT

1. Before we come to the arguments claimed by petitioners to support a grant of the writ, it should be pointed out that there are several affirmative reasons why this case should *not* now be brought here.

a. The judgment is far from a final one; all that it does is to remand an administrative order to the agency for further proceedings. The whole case is *in fieri*. Cf. *United States v. U. S. Smelting Co.*, 339 U.S. 186, 198. Certainly, the petition presents no question so extraordinary and fundamental as to call for a departure from the usual rule that this Court reviews only final judgments.

b. This rate case should not be decided piecemeal. The task it involves is to ascertain all of the items of revenue to which the regulated company is entitled, classify them according to their origins and functions, allocate them according to customers, or classes, or zones, and then translate them into rates. Every issue presented to the agency interacts with every other in this process; most of them present questions of administrative, not judicial, judgment; petitioners would have this Court tear out of the fabric one minor issue at the very beginning of the ratemaking process. When this case goes back to the Commission—as it must under the now-final mandate of the Court of Appeals in Nos. 18022, 18120 and 18124—the first job of the Commission will be to recompute, upon a new record, an important item of revenue. The principles upon which the Commission will act are unknown. Further review proceedings, further applications to the Court for certiorari, are more than merely probable. Any judgment of this Court on the single issue now presented to it would not decide the case; it would affect the course of further proceedings before the Commission, and further review proceedings, only as to one relatively minor and separate question.

c. There is no real, earnest or vital controversy between petitioners and the Commission, or between petitioners and El Paso with respect to the single issue presented.[8] Only in the most technical sense can it be said that petitioners are "aggrieved" at all by the decision of the Commission, or of the Court of Appeals. The parties actually and directly concerned with El Paso's rates for gas delivered to California—its large California distributor-customers, who were petitioners in Nos. 18120 and 18124 below—made no objection at all in the Court of Appeals to the Commission's disposition of the question here presented, and have disclaimed any desire to appear in this proceeding. If it be alleged that the "petitioners" are representing "consumer" interests, the answer is the same as that given by the Court of Appeals, District of Columbia Circuit, in the *Panhandle-City of Detroit* case with respect to liberalized depreciation: "the solution of the Commission does not result in higher rates to the consumer. It simply does not operate to reduce them. It aids [the pipeline company] but neither aids nor harms petitioners. . . . this is the result sought by Congress." *City of Detroit v. FPC*, 230 F.2d 810, 822, cert. denied 352 U.S. 829.

2. The petition makes only the faintest claim of advancing any reason, in support of the prayer for the writ, of the character contemplated by Rule 19. Amounts running into nine figures are printed in an attempt to arrest the Court's attention and magnify

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[8] The nominal petitioners are the "People of the State of California" and the Public Utilities Commission of that State. Counsel for the PUC invoke CALIF. PUB. UTIL. CODE § 307, Pet. 4, n. 6, as investing them with the right to represent "the people" here; but this is surely a tendentious reading of that code section, which authorizes PUC counsel thus to appear only in "actions and proceedings involving any question under this part"—*i.e.* Part 1 of Division 1 of the Public Utilities Code—"or under any order or act of the commission"—*i.e.* the *California* Commission. This proceeding involves neither sort of question. The naming of the "People of the State of California" as a party, doubtless in the hope that Courts will be impressed that large State interests are at stake, may be a harmless pretense, but is a pretense all the same.

the proportions of the problem. Pet. 13. But natural gas cases inherently involve very large figures (for example, El Paso's rate base in the test year was over half a billion dollars, R. 183, and is now little short of a billion). The fact is that the amount involved for the test year in the question here presented is less than .00806 of El Paso's cost of service for the test year, R. 188, and the relationships of the amount involved industry-wide to other aspects of the natural gas business are similarly minuscule.

Other arguments relied on bear little or no resemblance to the standards of Rule 19. No conflict of decision is or could be claimed. *Infra*, p. 11. It is said that "only actual taxes have ordinarily been allowed in calculating the cost of service." Pet. 14. Even were this true, it would amount to no more than an episodic departure from what has "ordinarily been allowed," scarcely calling for this Court's interposition. The fact is, however, that the Commission has been held compelled, for reasons no more cogent than those underlying liberalized depreciation, to allow even to an electric utility more than actual taxes;[9] and the same is true of every case in which the tax benefits of accelerated amortization or liberalized depreciation have been allowed.[10]

It is said that "the use of liberalized depreciation results in a tax saving, not a tax deferral". Pet. 16; but the Commission held that it "operates to create a deferral of income taxes." R. 171-172. It decided that current "income taxes for the year are lower because of the use of liberalized depreciation," but since liberalized depreciation applies to particular items and not to the property as a whole, depreciation deductions in the future will become less, and taxes increased, with respect to those items on which liberalized depreciation is taken. R. 173. The Court below agreed that "in practical effect" the use of liberalized depreciation "works a tax deferral rather than a tax saving." R. 290-91. Surely this fact question[11] is not one as to which this Court is better equipped to make the necessary predictions. Pet. 17-18, about the future economy and technology of the natural-gas industry than is the Commission.

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[9] *South Carolina Generating Co. v. FPC*, 249 F.2d 755, cert. denied 356 U.S. 912; s.c. on second appeal, 261 F.2d 915.

[10] *E.g., Panhandle Eastern Pipe Line Co.*, 3 P.U.R. 3d 396, affirmed as to this point and reversed on other grounds *sub nom. City of Detroit v. FPC*, 230 F.2d 810, cert. denied 352 U.S. 829; *Amere Gas Utilities Co.*, 15 F.P.C. 760; *El Paso Natural Gas Co.*, CCH UTIL. LAW REP. ¶9438; *Olin Gas Transmission Corp.*, 17 F.P.C. 685.

It is said that the Court of Appeals unwarrantedly assumed that if El Paso had to pay higher taxes in the future, it would not be entitled to a rate adjustment. Pet. 18. But this is only argumentation, and this Court does not sit to revise opinions for the Courts of Appeals. Nor is it true that tax "normalization" has been a one-way street in Commission practice: the very first case on the subject[12] held that a tax allowance should be "normalized" to reflect *less* than actual taxes paid, contrary to petitioners' assertion that such an event "is not only unlikely but, in our opinion, would never occur." Pet. 21. Both Commission and Court of Appeals took note of the fact that the tax benefits of liberalized depreciation are required to be accounted for in a reserve for deferred taxes. R. 173-74, 291. The tax benefits therefore cannot represent added return, cannot increase earnings available for dividends, and will necessarily be available to meet future increased taxes.

Finally, it is said that consumers "are unlawfully compelled to make capital contributions", Pet. 21, and are "deprived of the benefit of lower rates." Pet. 23. The fact is that the consumer is neither injured nor aided by the Commission's treatment of the tax benefits, R. 174, and these arguments are merely colorful—and inaccurate—characterizations of the transaction. El Paso Gas sells gas to distributing companies under FPC tariffs. The distributors sell it to consumers under other tariffs on file with California PUC. The consumers pay for gas, and only for gas. "Their payments are not contributions to depreciation or other operating expenses, or to capital of the company." *Board of Comm'rs v. New York Tel. Co.*, 271 U.S. 23, 32.[13] The allowance to the seller, as intended by Congress, of the tax benefits of accelerated amortization and liberalized depreciation, "does not result in higher rates to the consumer. It simply does not operate to reduce them." Nothing in the Natural Gas Act requires "the Commission always to set rates at the very brink of confiscation." *City of Detroit v. FPC*, 230 F.2d 810, 815, 822, cert. denied 352 U.S. 829.

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[11] The "two-court rule" barring review here of District Court factual determinations approved by a Court of Appeals should *a fortiori* apply to facts found by a specialized agency.

[12] *City of Detroit v. Panhandle Eastern Pipe Line Co.*, 3 F.P.C. 273, 290-92. The review proceedings, which culminated in this Court's decision in *Panhandle Eastern Pipe Line Co. v. FPC*, 324 U.S. 635, did not involve this issue.

The petition, in fine, presents a series of propositions, plausible so far as they go, by way of quarrel with the Court of Appeals' decision, but no special and important reasons why this Court's energies should be engaged in reviewing what the Court of Appeals has rejected.

3. There is in point of fact nothing in the question presented which meets the standards that call for review by this Court. The only two Circuits which have considered the matter are in agreement. The decision of the District of Columbia Circuit in the *City of Detroit* case on accelerated amortization is squarely in accordance with the decision of the Fifth Circuit here on liberalized depreciation. As the Commission has more than once held, the principles governing those two problems are precisely the same. R. 171-72; *Amere Gas Utilities Co.*, 15 F.P.C. 781.

The regulatory agencies are also in agreement. Less than two months ago, the Civil Aeronautics Board, relying on FPC's *Amere* decision, decided the question here presented exactly in accordance with the decision of the Commission in this case, which the Court below approved. *General Passenger Fare Investigation*, 29 U.S.L. WEEK 2267 (CAB Docket No. 8008, Nov. 25, 1960).

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[13] *Cf. Treatment of Federal Income Taxes*, 12 F.P.C. 369, 372: "No contribution is made by the customers or by anyone else."

The issue presented by the petition is of little importance on this record, and of even less beyond it. We know of no litigant before the Commission, except California PUC, which has refused to accept the Commission's decision on liberalized depreciation.[14] Indeed, as we have said, in this case the parties affected by it—El Paso's customers—made no objection at all in the Court of Appeals to the Commission's decision on the point. Except to California PUC, the question it presents is a dead issue, and has been ever since the Court of Appeals' *City of Detroit* decision five years ago.[15]

4. As repeatedly held by the Commission, and by the District of Columbia Circuit, §§ 167 and 168 of the Internal Revenue Code have underlying them a specific Congressional policy which it is the duty of the Commission to fulfil, just as much as it is the Commission's duty to enforce the Gas Act itself. R. 262. That policy is to encourage the construction of plant and equipment for defense purposes and to stimulate the economy generally. Absent the tax benefits, there would be no such stimulus—or at least so Congress believed. It is not, we respectfully submit, for courts to say that Congress was mistaken, or that the tax benefits should be transferred to persons on whom Congress did not confer them.

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[14] California PUC's intransigence on the subject may well stem from the fact that it, along with a minority of other state commissions, has required utilities subject to its jurisdiction to pass the tax benefits on to their customers. *Rate Fixing Treatment for Accelerated Depreciation*, 57 Cal. P.U.C. 598 (April 12, 1960) (3-2 decision). Most state commissions agree with the federal agencies that Congress intended the tax benefits for the taxpayer, not its customers. Poth, *Regulatory Treatment of Accelerated Depreciation*, 65 PUB. UTIL. FORTNIGHTLY 830, 841-42.

[15] Although two petitions for certiorari were filed in the *City of Detroit* case, nobody even challenged the Court of Appeals' decision on this question. Nos. 98, 113, O.T. 1956, denied at 352 U.S. 829.

The District of Columbia Circuit in the *City of Detroit* case has this to say about the present question (230 F.2d at 822):

> ". . . the Commission . . . concluded, we think correctly, that the intent of Congress reflected in section 124A[16] is not to benefit consumers but rather the taxpayer. . . . In placing the savings at the disposal of Panhandle under the limitations specified, the Congressional intent is effectuated. . . . Unless this is permitted, it is difficult to see how Panhandle could benefit substantially from section 124A. This statute, unlike the Natural Gas Act itself, is not for consumer benefit. It has a different public policy and should be given effect as intended by Congress. Furthermore, the solution of the Commission does not result in higher rates to the consumer. It simply does not operate to reduce them. It aids Panhandle but neither aids nor harms petitioners. We think this is the result sought by Congress."

The fact that the Commission's treatment "does not operate to reduce" rates does not mean that the consumer is disserved. The interest of gas consumers lies not only in reasonable rates, but also in adequate supplies. To transport gas from the producing fields of the South and Southwest to the great consuming centers of the Atlantic Seaboard, the Midwest and the West Coast requires stupendous investments. The Commission has no power to require such investments to be made. Act § 7(a), *proviso*, and unless the promises of Congress are fulfilled with respect to natural gas companies as they are to other taxpayers, any incentive to build the required new facilities will vanish.

The decision below does no more than preserve the incentive, without any increase in rates. It fulfils the objectives of Congress embodied both in the Internal Revenue Code and in the Natural Gas Act.

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[16] Of the Internal Revenue Code of 1939; now section 168 of the Internal Revenue Code of 1954.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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January 19, 1961

FILE COPY

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In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 599

PEOPLE OF THE STATE OF CALIFORNIA AND
PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA,
Petitioners,

VS.

FEDERAL POWER COMMISSION and
EL PASO NATURAL GAS COMPANY,
Respondents.

On Petition for a Writ of Certiorari to the United States
Court of Appeals for the Fifth Circuit

Motion [redacted] Petition for Rehearing of Order Denying Petition for Writ of Certiorari

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In the Supreme Court of the United States

October Term, 1960

No. 599

People of the State of California and
Public Utilities Commission of
the State of California,

Petitioners,

vs.

Federal Power Commission and
El Paso Natural Gas Company,

Respondents.

On Petition for a Writ of Certiorari to the United States
Court of Appeals for the Fifth Circuit

Motion for Leave to File and Petition for Rehearing of Order Denying Petition for Writ of Certiorari

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MOTION FOR LEAVE TO FILE PETITION FOR REHEARING

Come now the People of the State of California and Public Utilities Commission of the State of California (California), petitioners herein, and move this Court for leave to file petition for rehearing of the order of this Court, entered on May 1, 1961, in this cause, denying the petition for a writ of certiorari heretofore filed.

Petitioners state that the grave public importance in this case is such that the petition for writ of certiorari should be granted and that the substantial issue presented to the Court be passed upon other than by the inconclusive disposition inherent in the failure of the Court to grant the writ.

Respectfully submitted,

William M. Bennett
Chief Counsel

J. Calvin Simpson
Senior Counsel

Attorneys for the People of the State of California and the Public Utilities Commission of the State of California.

May 24, 1961

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR A WRIT OF CERTIORARI

Come now Petitioners and request this Court to grant rehearing of its order denying petition for a writ of certiorari heretofore entered in this cause and for the reasons hereinafter set forth respectfully request that the writ issue.

REASONS FOR GRANTING REHEARING AND ISSUING THE WRIT

1. The Decision Upsets Basic Utility Regulation

Historically and consistently, utility rates have proceeded from an examination of actual utility costs and expenses. Ratepayers have never been charged with operating costs which were not realities. For the first time in the history of rate regulation and for the first time under the Natural Gas Act, the Federal Power Commission has departed from that accepted formula of regulation.

2. The Dollar Impact of Such a Decision

Recognizing as charges tax costs not in fact incurred requires ratepayers affected by the regulated segment of the oil and gas industry to pay over monies for non-existent or phantom taxes. Such a windfall is contrary to all conventional rate making and imposes an unnecessary and heavy burden upon ratepayers, to the unjust enrichment of utilities. It requires the ratepayer to contribute capital, which historically has been the function of the investor. Going further, it requires the ratepayer, in the charges he pays for services, to pay a return upon the plant constructed with capital furnished by the ratepayer.

3. The Consequences in the Future

The brief amici curiae of the Commonwealth of Pennsylvania and other parties herein discloses that to date over one billion dollars has been accumulated by national electric utilities by this device and placed in that account labeled "Reserve for Deferred Taxes". Such a sum represents capital contributed by the ratepayer for taxes which do not have to be paid and poses a most difficult problem for the regulatory commission in recognizing the proper source of such funds to dispose of them. The deprivation of any sum, unless justified in law or in fact, is error, as here. A departure from the concept of actual costs and actual taxes has permitted the growth of exorbitant sums which, because of the complexities of utility finance and utility operation, may well have been irrevocably given over to the utilities affected. Actual experience has demonstrated that it is no easy task to require, either by way of refund or appropriation to some expense for the benefit of the ratepayer, disposition of such vast sums of money, which disposition is compelled when recognition is given ultimately to the proper source and the nature of such funds.

4. The Tax Reserve in the Present Case

California ratepayers and other system ratepayers have been and will be compelled to pay to the El Paso Natural Gas Company sums ostensibly for taxes, but which admittedly are not used for such purposes. In essence, just why should a ratepayer give up so much as a penny unless required as an actual cost or an actual expense properly to be paid over for service rendered?

The disposition of such a growing fund poses many problems for the utility in this case, requiring it, upon the day of reckoning, to pay back the reserve in some unknown manner or, in the alternative, to incur money costs for such disposition. Extended thinking upon this problem will disclose many problems which this Court, by granting the writ in this case, could resolve.

5. The Realities of the Tax Burden

The El Paso Natural Gas Company is usually in the fortunate position of paying no federal income taxes. This statement and its full impact must be measured against the requirement of the Federal Power Commission and the decision below that El Paso's ratepayers are to be charged for non-existent tax expenses. Why? If no tax liability existed in the past, and it seems reasonable that such a situation will continue into the future because of the statutory depletion and intangible well-drilling expense deductions, as well as others available, then what purpose is served by taking away from a ratepayer money which is precious to him and placing it into an account awkwardly named, in view of the tax reality, "Reserve for Deferred Taxes"? It is a demonstrable fact that the day of tax reckoning feared by utilities as a result of their use of liberalized depreciation under Section 167 of the Internal Revenue Code will never arrive so long as a company is marked for replacement and growth—as is the undeniable fact with reference to this pipeline corporation.

6. The Public Importance and the Meaning of the Court's Refusal to Grant Certiorari

California is aware that in the narrow legal sense the denial of certiorari is not a judgment upon the merits of an issue. Nonetheless, the realities of the situation impel us to seek rehearing in a cause so momentous as this. The great example set by the action of the Court here has already settled the position upon the part of utilities that they are entitled to collect and to keep the entire reserve for deferred taxes, with no benefit to the ratepayer. The argument of the Government that this is a discretionary matter breaks faith with the clear administrative ruling of the Federal Power Commission herein when it stated that it was compelled to permit a pipeline utility to collect rates and charges for non-existent taxes because the Congress so intended. Discretion at agency level was ruled out.

The decision of the court below of necessity adopted the reasoning and conclusions of the Federal Power Commission, and inevitably it must be conceded that strong argument lies in favor of the proposition that this is no longer discretionary. Whether it is or is not is the very issue this Court should pass upon by granting the writ.

7. The Treatment to Be Accorded California

It is all-important to California and to all consumers affected by the segment of the oil and gas industry regulated by the Federal Power Commission that this matter be resolved. It is all-important that the Supreme Court speak out upon the merits of this controversy so that its silence here may not be interpreted as an approval by this and other federal agencies, as well as state commissions, of the treatment accorded in this case.

This matter is now remanded to the Federal Power Commission for further action, and the question properly arises which treatment is to be given in these proceedings. Is El Paso to retain all of the monies collected and to continue to collect them with no benefit to the ratepayer or is El Paso in this case to be accorded the same treatment by this agency recently expounded as to this issue concerning other pipelines? Does the Federal Power Commission, in view of its clear language in the El Paso case, affirmed upon appeal, retain discretion to change its mind so drastically?

CONCLUSION

California respectfully requests this Court that the petition for a writ of certiorari herein be granted so that the complexities and the importance of the issue before the Court can be fully briefed and fully argued and that a decision upon an issue of such economic magnitude can have the meaning it properly should.

Respectfully submitted,

William M. Bennett
Chief Counsel

J. Calvin Simpson
Senior Counsel

Attorneys for the People of the State of California and the Public Utilities Commission of the State of California.

May 24, 1961.

CERTIFICATE OF COUNSEL

I hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay and is restricted to grounds specified in Rule 58(2) of the rules of this Court.

William M. Bennett
William M. Bennett

Counsel for Petitioners

May 24, 1961